WHITHER RUPEE?

A Study in the Ratio Controversy

By the Same Author

INDO-JAPANESE COMMERCIAL AGREEMENT

TRENDS OF AGRICULTURE AND POPULATION IN THE GANGES VALLEY: A STUDY IN AGRICULTURAL ECONOMICS

WHITHER RUPEE?

A Study in the Ratio Controversy

by

BIRENDRANATH GANGULI, M.A., Ph. D.

Professor of Economics, Hindu College, Delhi,
Reader in Economics, University of Delhi,
Prem Chand Roy Chand Student and
Mahendra Roy Prizeman, University of Calcutta

FOREWORD BY

PRAMATHANATH BANERJEA,
M A , D.Sc., (Lond.)

Barrister-at-law, M.L.A , Fellow and Syndic,
University of Calcutta; Formerly Minto
Professor of Economics, University of Calcutta,

S. Chand & Co.

Chandni Chowk, Delhi.

FIRST PUBLISHED 1939

PRINTED AT THE BALUJA PRESS, DELHI.

FOREWORD

The value of India's currency is one of the most controversial questions of the present day. Even when the question is considered from the purely economic standpoint, it provides ample scope for differences of opinion. In no country of the world are the interests of the producer and the consumer, of the exporter and the importer, of the tax-payer and the tax-gatherer, always identical. It is, therefore, not unnatural for the different classes of a community to look at the currency question from different angles of vision. This difficulty is not peculiar to India, but in this country the position is further complicated by its political situation. India is still a subject country, and the interests of the rulers are often quite different from those of the ruled. Therefore, the solution of the ratio question is one of the greatest difficulty in India. An economist, however, is expected to study the problem with an unbiassed mind and a broader outlook. I am happy to note that the method of approach in this work is a scientific one. The author has based his study of the subject on a careful analysis of all relevant facts.

Although the "ideal ratio" is always difficult to to attain, yet it can hardly be denied that the most

fundamental characteristic of a correct ratio is that it is "easily maintainable". The 1s. 4d. ratio fixed in 1898 answered this test to a large extent. It was maintained without much difficulty for nearly twenty years, and its breakdown was due to the abnormal circumstances created by the Great War. The 2s. ratio announced in 1920 was neither attainable nor maintainable, and the folly of the experiment caused a huge financial loss to the country. It was possible to maintain the 1s. 6d. gold ratio adopted in 1927 for a few years on account of the special conditions which prevailed during the period, but it was unable to stand the strain of the economic crisis. When the rupee was linked in 1931 with sterling at the 1s. 6d. rate, many Indian economists raised their voice of protest, but this went unheeded. That their view was correct has been proved by the subsequent course of events. This ratio was maintained for some years by the adventitious aid of the export of gold, but since the disappearance of this special circumstance it has been found exceedingly difficult to maintain it. Apart, however, from the difficulty of maintaining the ratio, no fair-minded person acquainted with the economic situation of the country can deny that the 1s. 6d. rate has placed the agriculturists as well as the industrialists of India at a great disadvantage during the last eight years.

In the first chapter the author presents the facts bearing on Indian currency and exchange after the Easter week of April, 1938 when Indian exchange weakened and sagged and the Reserve Bank had to discontinue the purchase of sterling until further notice for the first time after its inception. The intrinsic weakness of the rupee-sterling exchange was due to the collapse of the boom of 1936 which occurred in the first quarter of 1937 and was followed by a world-wide trade recession. The author discusses carefully how the Reserve Bank reacted to the difficult situation created by the suspension of the purchase of sterling coupled with the urgent need of putting through the remittance programme of the Government of India. He analyses and interprets a mass of facts revealed by the weekly statements on the affairs of the Reserve Bank in order to reach his particular conclusions. As he has shown by means of statistics relating to the sale of Treasury Bills, the Bank did not interfere with the easy money policy and move in the direction of contraction of credit. But owing to the depletion of the foreign balances of the Banking Department there were inroads upon the sterling securities held as assets of the Issue Department, although it appears that the Government of India were also repatriating their sterling debt to some extent. The author discusses next how far the

withdrawal of sterling securities meant a contraction of note-issue. An interesting fact emphasized by him in this connection is that the percentage of 'A' portion of the assets of the Issue Department to liabilities was lowered appreciably, so that the deflationary effect of the withdrawal of sterling securities was to that extent neutralized. Moreover, the limit up to which these securities could be utilized without deflationary effect was by no means reached. The author next draws our attention to the phenomenal shrinkage of notes in active circulation and discusses in the light of the advanced ideas of modern monetary theory how far this could be explained as being due to 'active deflation'.

In the second chapter the author reviews the situation as it developed between August and December last. During this period the depreciation of sterling in relation to dollar eased the critical situation by stimulating exports of gold as well as of merchandise to some extent. The continued monetary stringency created by the Treasury Bills operations of the Reserve Bank also contributed to the steadiness of the Ready rate of exchange. But the author argues that the intrinsic basis of the rupee-sterling exchange was nevertheless shaky and vulnerable.

In the third chapter the author discusses the

problem of devaluation in a wider setting. He examines the rationalé of post-war monetary stabilization in India and comes to the conclusion that the known criteria of monetary stabilization were not applied to the evolution of monetary policy. He refers particularly to the fundamental change in the barter terms of trade of agricultural countries which did not receive the attention it deserved at the time when the rupee was revalued in 1927. During the depression agricultural countries tried to reach external equilibrium in the face of the shrinking quantum of exports by exportation of gold and eventually by devaluation of their currencics. India joined the general movement for devaluation under the leadership of England. But the author has shown by a careful study of facts that during the depression the rupee was as intolerable as gold currencies from the point of view of foreign trade and internal prices. The heavy price deflation in India was without parallel in the sterling bloc, and our economic life was subjected to a paralysing process of deflationary contraction. In this respect, as the author shows, the situation was different in countries which were free to pursue an independent currency policy, and he has demonstrated that India's currency policy was warranted "neither by the professions of her accredited representatives nor by the theory and the practice of post-war currency

stabilization."

In the concluding chapter the author surveys the ratio controversy against the general background prepared in the earlier chapters. He gives us a critical estimate of the resolution of the Congress Working Committee and of the communiqué issued by the Government of India in reply to that resolution. Apart from the fact that it is hardly possible to say at present that there is an upturn in the cycle of business activity and that the crisis of the rupee is over, devaluation, according to the author, is necessary on more fundamental grounds. "Our economic policy must necessarily be broad-based on the fundamental objective of correcting the distortions in the structure of prices and production created by the Depression" and "distributing the loss of real income quickly and evenly over all classes of the community". The author rightly thinks that devaluation is an indispensable *aid* to such an economic policy which must be based on "a co-ordinated programme in which both monetary and non-monetary measures are combined and assimilated." He concludes his study by sketching out the general outlines of such a national programme.

The author's conclusions have been arrived at as the result of an independent investigation of facts.

Dr. B. N. Ganguly is not only a distinguished scholar but also a teacher of considerable experience, and the present work fully maintains his reputation. It is a valuable contribution to the study of a complex and difficult subject.

Pramathanath Banerjea.

PREFACE

This study in the Ratio Controversy does not pretend to be exhaustive. All that has been attempted is an examination of some of the more conspicuous and fundamental aspects of this controversy in a wider setting. The field that I have covered has been the battle-ground of contending economic interests and rival monetary principles. When a subject like this is approached in a polemical spirit one is apt to develop a pontifical attitude and form dogmatic opinions. For my part, I have tried to present a plain, unvarnished and scientific account of facts and tendencies in a spirit of detachment, and I leave it to the readers to judge how far I have been able to avoid the heat and dust of the polemical warfare that has raged round the eventful history of the rupee in recent years.

My attention was forcibly drawn to the Ratio Controversy in July 1938 when it was quite evident to impartial observers that the rupee-sterling exchange had been showing unmistakable signs of intrinsic weakness due proximately to the collapse of the short-lived boom of 1936. The greater part of this book was written under the shadow of an impending European war in the autumn of 1938 which upset the

markets of the world and heightened the effects of the world-wide trade recession in spite of the anti-cyclical effects of rearmament expenditure. It was finished by the end of the year when the prospect was none too rosy. I regret that its publication has been unavoidably delayed. But at the time of writing it seems that the lineaments of the problem of the rupee have not changed in such a manner as to warrant self-complacent optimism.

I should like to take this opportunity of thanking Dr. P. N. Banerjea for writing the introductory Foreword. I am indebted to Dr. H. L. Dey, Head of the Department of Economics, University of Dacca, for reading the manuscript with great care and making several helpful suggestions. I am also thankful to Dr. Amiya K. Das Gupta, my friend and former colleague at the Dacca University, for reading the manuscript with a critical eye and making a few valuable suggestions for improving the presentation of the argument. Lastly I have to thank Mr. Sourindranath Roy M. A. for very substantial assistance in reading the proofs and seeing the book through the press.

Birendranath Ganguli.

Hindu College,
May 15, 1939.

CONTENTS

CHAPTER I.

THE RUPEE-STERLING EXCHANGE AND THE OPERATIONS OF THE RESERVE BANK OF INDIA

(April, 1938 to July, 1938.)

After the celebrated ratio controversy had culminated in the statutory recognition of the present rupee ratio more than a decade ago the controversy was supposed to be as dead as Queen Anne, although attempts were made from time to time to impress upon the Government of India the need for reversion to the old ratio. Recently, however, since the intrinsic basis of the rupee-sterling exchange was threatened in no uncertain manner, devaluation of the rupee as an economic issue assumed an added significance. It began to be widely recognized not merely as a general device to initiate and speed up the process of economic rehabilitation and recovery, but also as the only weapon with which to fight a new economic menace caused by the recent trade recession and the sagging exchange. Thus we witness now a new orientation of the old ratio controversy which has undoubtedly entered a new phase after the lapse of a decade. In the second

week of December the Congress Working Committee demanded the immediate lowering of the rupee ratio to 1s. 4d., in a resolution containing facts, arguments and assertions expressed emphatically and in a decisive manner. Soon after the Government issued a communiqué in which in an equally emphatic and incisive manner they challenged the facts, repudiated the assertions and contested the arguments embodied in the resolution of the Working Committee. Devaluation as an economic issue has wider bearings and must be visualized in a broader perspective. But since it is from the proximate facts of the economic situation that the controversy has derived its piquancy and incisiveness it is necessary first to study these facts in a rational spirit.

After a period of comparative stability in its chequered course the rupee-sterling exchange entered an interesting and sensational phase in April, 1938. During the Easter week of April the Reserve Bank of India for the first time after several years accepted tenders of sterling at 1s. 6-3/32d., in stead of 1s. 6-1/8d., which it had been realizing for a fairly long time. As it accepted a small amount of sterling tenders at this rate the exchange market was thrown into a state of uncertainty. On April 27 no tenders for sterling were accepted, and it was

announced that tenders for sterling were discontinued until further notice. There was an immediate repercussion on Indian exchange, and the rate for T. T. on London Ready, which had remained stable at 1s. 5-3/32d. for a fairly long time, came down to 1s. 5-15/16d. on the following day. The subsequent course of the rupee-sterling exchange is illustrated in the following table.

T. T. on London Ready:

Date.		Rate.
April 19.	....	1s. 6-3/32d.
April 28.	....	1s. 5-15/16d.
May 5.	....	1s. 5-7/8d.
May 13.	....	1s. 5-7/8d.
May 20.	....	1s. 5-15/16d.
June 1.	....	1s. 5¾d.
June 8.	....	1s. 5¾d. to 1s. 5-25/32d.
June 15.	....	1s. 5-25/32d.
June 23.	....	1s. 5¾d.
June 30.	....	1s. 5-25/32d.
July 7.	....	1s. 5-27/32d.
July 14.	....	1s. 5-7/8d.
July 21.	....	1s. 5-7/8d.
July 28.	....	1s. 5-29/32d.

It will be observed that the downward tendency of the rupee-sterling exchange continued till June 8,

and on that date the T. T. rate was 11/32d. per rupee lower than the rate prevailing before the cessation of the purchase of sterling by the Reserve Bank. The fixing of the tap rate at 1s. 6-1/32d. towards the middle of the week ending the 7th May had to some extent a steadying effect on the market. But the impression had gained ground that the inherently precarious and vulnerable position of the rupee-sterling exchange was revealing itself in no uncertain manner, and that the situation would eventually have to be met by devaluation. In fact the situation became so critical that the T. T. rate of 1s. $5\frac{3}{4}$d., which ruled on the 1st June as well as on the 8th June, was lower than the minimum rate fixed for sale of sterling under Sec. 40 of the Reserve Bank Act, viz., 1s. 5-49/64d., by 1/64d. to the rupee. In order to reassure the market and discourage the operators who had been speculating for a fall in exchange the Government of India issued a communiqué on the 17th June notifying their intention to maintain the present rupee-sterling ratio. Besides asserting that this was necessary in the best interests of India, the Government of India reassured the market by explaining that the gold and sterling assets of the Reserve Bank amounting to more that Rs. 160 Crores were adequate for supporting the ratio. The announcement was well-timed and

served to restore confidence. On the 8th June there was an immediate rise in the T. T., rate from 1s. 5¾d., to 1s. 5-25/32d, and thereafter there was continued recovery. But there was certainly a speculative element in such a rise, as it was not warranted by the existing demand for remittance and the supply of export bills. During the week ending July 14 the Reserve Bank lowered the tap rate to 1s. 5-15/16d. This undoubtedly had a moderating influence on the speculative rise which was apt to mask the long-run tendencies. Moreover, by lowering the tap rate the Bank was expected to purchase sterling at 1s. 5-29/32d., provided there was trade recovery in the immediate future.

What were the proximate causes of the exchange debaclè? A complete study of all the causes, proximate as well as remote, will take us far afield, as these are linked up with the course of prices and producation, the structure of wages and other money incomes and the trend of employment and trade not only in India but also in other countries with which India has intimate commercial relations. Certain aspects of these wider and remote causes will be discussed at a later stage. Here it will be sufficient for us to fix our attention on India's Balance of Accounts which reflects powerfully the operation of proximate causes determining the course of foreign exchange.

JOINT BALANCE OF ACCOUNTS OF INDIA & BURMA

(In lakhs of Rs.)

Period.	Imports.	Exports.	Merchandise Balance.	Balance of transactions in treasure.	Sterling Purchases	Net visible Balance of Accounts.
1935–36	– 134,43	+ 164,29	+ 29,86	+ 36,69	– 45,58	+ 20,37
1936-37	– 125,24	+ 202,37	+ 77,13	+ 14,25	– 70,87	+ 20,51
1937-38	– 159,78	+ 202,25	+ 42,47	+ 14,84	– 33,29	+ 24,62
January.	– 15,08	+ 14,84	– 24	+ 1,72	– 4,33	– 2,80
February	– 11,72	+ 13,84	+ 2,12	+ 2,05	– 6,55	– 2,38
March	– 13,54	+ 16,28	+ 2,74	+ 73	– 6,46	– 2,99
April	– 12,13	+ 14,06	+ 1,93	+ 1,09	– 40	+ 2,62
May	– 12,37	+ 12,02	– 35	+ 62	×	+ 27

In so far as the visible items in the accounts are an indication of our solvency as a nation, the statistics set forth above are highly significant. It is well known that India's balance of accounts is predominantly governed by the exigencies of meeting her external contractual obligations as a debtor nation. It is the active merchandise balance of trade, together with the favourable balance of transactions in treasure in recent years, which is the source from which India's external obligations as a nation can be ultimately met, although temporarily a passive balance of accounts can be readjusted by increasing the volume of short-term foreign obligations.* Since the onset of depression the shrinking of India's active merchandise balance of trade has been considerably offset by the phenomenal exports of gold. The gold exports have, on the one hand, fortuitously helped the currency authorities to maintain foreign exchange on an even keel, and, on the other, have prevented the otherwise inevitable re-adjustment of the balance of trade to a lower level of imports in response to the serious fall in the volume and value of exports.†

* This alternative, limited in scope that it is, was out of the question owing to the easy money policy of the Reserve Bank which is discussed below.

† The smaller shrinkage in imports has also been explained by the operation of the system of Ottawa preferences, by the over-valuation of the rupee and also by the fact that import prices fell less sharply than export prices during the depression. It must be noted, however, that protective import duties have operated as a restrictive factor.

The second consequence has been welcomed by the Government of India no less warmly than the first. Since the volume and value of imports have diminished much less than the volume and value of exports, the yield of customs duties, the mainstay of the central budget, has not fallen to the anticipated extent and has thus contributed to budgetary equilibrium which, in the eyes of the Government of India, is the *sine qua non* of 'India's credit' abroad. At the same time the Indian market for British goods has not contracted to the extent to which it should otherwise have. Bearing these obvious facts in mind let us examine the situation as it had been developing in recent years.

In 1936-37 the active merchandise balance of trade was Rs. 77,13 lakhs, as against Rs. 28,86 lakhs in 1935-36. This increase was due to a substantial increase in the total value of exports and a decrease in the total value of imports. Although, at the same time, the increase in the active merchandise balance of trade was to some extent counterbalanced by a decrease in the balance of transactions in treasure, yet the position as regards the active visible balance of accounts was certainly more favourable to Indian exchange. Indeed the substantial increase in the amount of sterling purchased

by the Reserve Bank is highly significant in this connection.

In 1937-38, however, the position deteriorated. While there was a slight increase in the active balance of transactions in treasure (by Rs. 59 lakhs), the active merchandise balance of trade decreased from Rs. 77,13 lakhs to Rs. 42,47 lakhs. And it is significant that the volume of sterling purchase in 1937-38 was *less than half* of what it had been in the previous year. During the first three months of 1938 the situation worsened, and the active merchandise balance of trade taken together with the active balance of transactions in treasure, being insufficient to balance the Reserve Bank's purchases of sterling, there was a passive visible balance of accounts which was bound to weaken the basis of the rupee-sterling exchange. The intrinsic weakness of the Indian exchange eventually asserted itself in April, and, as already explained, the Reserve Bank was compelled to withdraw from the exchange market as purchaser of sterling.

The underlying cause behind these tendencies was the collapse of the boom of 1936 which occurred in the first quarter of 1937. The depression which followed gathered momentum during 1937. But the process of contraction continued during the first half

of 1938 and showed no signs of exhausting itself. In fact it seemed impossible to regard the economic relapse "As no more than a trade recession from which recovery would in due course automatically ensue."* The financial experts of the League of Nations in the document which they prepared for the Financial Committee expressed the belief that "A serious world economic crisis largely due to the trade depression which began in the United States some twelve months ago and spread, though with less severity, to Britain and France, is imminent. Though these are only three countries they include the foremost trading nations, and their condition will certainly affect the whole world decisively".† This time also the process of contraction started in America where Wall Street slumped badly. The nature of the American crisis is evident from a few facts quoted in a recent circular of the National City Bank of New York. "The American steel industry which had worked to 92 per cent of capacity in the spring of 1937, dropped to about 35 per cent a year later. Orders for machinery and commercial equipment fell heavily. Railway goods traffic sank to the lowest levels since 1933; as did the half-year's production of automobiles".‡ The economic strain caused by the slump

* The *Spectator*. July, 15, 1938. P. 91.
† Ibid. P. 91.
The *Spectator*. August 12. 1238. P. 253.

was much less severe in Europe, but its repercussions there were clearly discernible. There was no doubt that the Wall Street slump had spread to other centres causing nervousness and hesitancy, and since existing securities were sagging there was less of borrowing for expansion, so that there was a a general contraction of business activity. Speaking of Great Britain the *Spectator* observed that "June, July and August are normally the best months for employment in the year, and at present we are on the crest of a huge wave of Government expenditure upon re-armament. In these circumstances it is surely a startling fact that our July unemployment should be not only worse, but much worse, than the unemployment not only of July, 1937, but of any single month during last year".* In India the repercussions ol the slump were quite patent. The crash of the boom of 1936 in the first quarter of 1937 and the stock exchange slump were not merely domestic phenomena unrelated to the world-wide recession in trade. Virtually there were no new company floatations during the greater part of 1937 and even in 1938 internal markets slumped heavily. Our active merchandise balance of trade shrank at an ominous rate. Statistics of the Post and Telegraph Department which provide

* Ibid. Page. 253.

a reliable index to trade movements showed that the surplus of about a quarter of a lakh budgeted for by the Department this year (1938-39) was not likely to be realized owing to the serious fall in revenue. Similarly railway returns reflected a decline in trade. From the beginning of the present financial year (1938-39), that is, for the months of April, May, June, July and August, the railway earnings amounted to a total of just over Rs. 38 crores which was Rs. 26 lakhs less than the returns for the corresponding period of last year, thus showing a deficit of over Rs. 5 lakhs per month. But the most serious aspect of the slump was that there had been a heavy fall in the prices of primary products. The *Economist* index of primary products registered a fall from 181.9 to 132.2 between March, 1937 and May, 1938. In fact it was until the last days of June 1938 that both the producers and consumers of primary products as well as the investors had been paying the price of over-confidence which they had displayed in the spring of 1937. Consumers had unwisely over-bought during a period of rising prices, and the stocks of essential raw materials were piling up more heavily than was justified by the orders which were coming in fast. When eventually prices towards the end of 1937 were in many cases less than half, industrial consu-

mers of primary products found themselves burdened with stocks bought at top prices for which they could not find a certain outlet. Hence unless they could be sure that the bottom of the slump had been reached by the middle of 1938 and prices were definitely on the up-grade, they were not expected to undertake expansion and build up stocks again. For the sake of a correct perspective it is necessary to bear in mind that it was in such an atmosphere of acute hesitancy and depression that devaluation of the rupee as an economic issue engaged the serious attention of economists, statesmen and businessmen.

It is necessary to examine how the Reserve Bank reacted to the difficult situation created by the suspension of the purchase of sterling coupled with the urgent need for putting through the remittance programme of the Government of India during the slack season. A careful study of this question within the limits of the available data will not only throw light on the technique of currency management evolved by the Reserve Bank, but will also reveal how far, if at all, the Bank has prevented a 'natural' level of the rupee-sterling exchange from establishing itself, or, in other words, has regulated currency and credit so as to maintain the statutory ratio of 1s. 6d. in the face of an inherently sagging exchange.

The first impact of the weakening of exchange was felt on the sterling purchases of the Reserve Bank. We have shown how the volume of sterling purchases had been shrinking recently owing to the gradually shrinking basis of sterling remittance. During the period of heavy gold exports the enormous sterling resources obtained through the process of transfer of the sale proceeds of gold to India were very wisely utilised by the Government of India in wiping off our external indebtedness to a considerable extent. Recently the Government of India stated before the Legislative Assembly Public Accounts Committee that "The export of bullion from India that had occurred during the last few years had been equalled by the repatriation of sterling debt and accumulation of sterling securities which had been effected to the amount of nearly Rs. 50 Crores and has thus strengthened India's credit to this amount". * The decrease in gold exports later on exercised a restrictive influence on sterling purchases. But the decrease in sterling purchases from Rs. 70,87 lakhs in 1936-37 to Rs. 33,29 lakhs in 1937-38 could not be explained by a reduction of gold exports, because the active balance of transactions in treasure in 1937-38 was actually more than that in 1936-37 by Rs. 59 lakhs.

* *Indian Information Series*, August 15, 1938. Page 75

The fact, therefore, seems to be that the serious shrinkage in the active merchandise balance of trade was making it more and more difficult for the Reserve Bank to obtain adequately large sterling tenders at 1s. 6-1/8d. Earlier in 1938 the comparatively high yield on Treasury Bills had tempted out foreign funds to seek short-term investment in the floating debt of the Government of India, and consequently the sterling purchases of the Reserve Bank were considerable. But as the resources of the money-market gradually became more than equal to the current trade demand, and as the floating funds swelled in volume owing to the excess of maturities of Treasury Bills over sales, the yield on Treasury Bills was reduced, so that the offer of sterling tenders as well as the amount purchased suffered a considerable decline *pari passu* with the weakening position of the rupee-sterling exchange. Thus eventually during the Easter week in April the Reserve Bank was compelled to accept a small amount of sterling tenders at 1s. 6-3/23d. and ultimately to discontinue purchases of sterling. The withdrawal of the Reserve Bank from the exchange market was certainly a wisely calculated step in view of the inherently weak position of the rupee-sterling exchange. Moreover, the lowering of the tap rate to 1s. 5-15/16d., was also a step in the

right direction. Since it implied a frank recognition of the fact that the fall of exchange was not a mere passing phase in the course of normal exchange fluctuations it prevented serious instability and dislocation which would have been inevitable if a speculative rise in the T.T. rate had been encouraged. Again, the lowering of the tap rate made the way clear for the purchase of sterling at 1s. 5-29/32d. if and when there was recovery of trade in the immediate future.

At the time when it was announced that sterling tenders were discontinued till further notice due to falling exchange the interesting question that arose was, how was the Reserve Bank to meet the requirements of sterling for putting through the remittance programme of the Government of India? It was clear that the Bank would have had to adopt the obvious expedient of utilising its sterling resources to meet the requirements of sterling remittance. But it was feared that such a process involved a deflationary interference with currency and credit and was bound to intensify the economic depression by further dislocating the structure of prices, wages, production and employment. The *Financial News* of London commented in this connection that "This process cannot be carried *too far* without interfering with the easy money

policy". Before we discuss how far this process was carried and whether it set deflationary forces in operation, we should examine whether the Reserve Bank "interfered with the easy money policy" and moved in the direction of contraction of credit. The statistics relating to the sale of Treasury Bills give a clear indication of the policy pursued by the Reserve Bank in this connection,

Even a casual study of these statistics (See Table on page 18) will convince anybody that the Reserve Bank was steadily pursuing a cheap money policy. In the first place, the principle which broadly speaking seems to have been followed is that the weekly sales of Treasury Bills should be adjusted to the weekly maturities. It was seldom that it took more investible funds from the short-term market than it put back in the shape of maturities. On the other hand, frequently the total maturities exceeded the total sales as in the three consecutive weeks of July. Consequently the Reserve Bank not only did not create artificial stringency by increasing the floating debt of the Government of India but it even actually reduced the volume of the outstanding floating debt by keeping its sales of Treasury Bills on a moderate level which was justified by the prevailing 'easiness' of the money market. Thus the floating

THREE MONTHS' TREASURY BILLS *(In lakhs of Rs.)*

1938, week ending		Total Sales	Total Maturity	Total Tendered	Average discount on accepted tenders per annum Rs.	As.	Ps.
April	7	2,00	100	369·50	1	8	10
„	14	2,00	200	395·00	1	8	3
„	21	2,00	200	220·75	1	8	7
„	28	2,00	200	311·25	1	8	10
May	5	1,50	200	315·25	1	7	7
„	12	1,00	150	272·50	1	6	4
„	19	1,00	150	118·25	1	6	11
„	26	65·25	100	155·50	1	6	4
June	2	82	100	137·00	1	6	5
„	9	1,00	100	65·25	1	6	0
„	16	1,00	100	229·50	1	4	0
„	23	1,00	100	328·00	1	2	3
„	30	1,00	100	268·25	1	0	8
July	7	1,49·75	100	356·75	0	15	4
„	14	1,50	200	251·75	0	14	0
„	21	1,50	200	247·00	0	12	11
„	28	1,50	200	284·75	0	11	0

debt which stood at Rs. 19 crores in April came down to Rs. 17 crores and 15¼ lakhs by the end of May, and after an increase to Rs. 18 crores and 47 lakhs in the beginning of July came down to Rs. 16 crores and 97 lakhs on the 28th July. In the second place, the steadily falling rate of accepted tenders was by itself a clear refutation of the opinion expressed by some that in view of falling exchange the Reserve Bank would tighten up the money rates. As already said, earlier in March the average discount on accepted tenders had been perhaps higher than what was justified by the prevailing conditions of the Indian market, and the higher yield on Treasury Bills was perhaps needed to attract foreign funds and thus facilitate the sterling purchases of the Reserve bank. But this movement was short-lived, and it is quite plain that the Bank did not seriously consider the possibility of removing the scarcity of sterling by this means. Later on also the floatation of new loans by the Government of India, the Calcutta Corporation, the Calcutta Port Trust, the Port of Rangoon and subsequently by the Provincial Governments had also had the effect of pushing up the yield on Treasury Bills. But the Reserve Bank steadily pursued an easy money policy throughout not only to maintain the stability of the new internal capital market which it is its duty to foster and control,

but also to create a proper atmosphere for the reception of the new loan issues. Indeed when we find that the average discount on accepted tenders declined from Re.1-8as.-10 pies early in April, to as much as only 11 annas by the end of July we discover a clear determination on the part of the Reserve Bank neither to create artificial conditions in the money market and give it a false scent nor to tighten up money rates and give rise to deflationary tendencies in the investment market. And in view of the fact that, notwithstanding the drastic reduction in the discount offered by the Reserve Bank on Treasury Bills, the total volume of tenders was still considerable one should not hesitate to admit that the Bank had been giving a correct lead to the money market.

It is, however, necessary to emphasize that a different policy, viz., a deflationary contraction of credit by tightening up money rates, not only had the least chance of success but was also fraught with serious economic consequences. It should be borne in mind that the weakening of the rupee-sterling exchange occurred at the fag-end of the busy season. During the slack season a far more drastic stiffening up of money rates than is practicable would have been necessary to strengthen the basis of the external value of the rupee specially when the intrinsic

position of the rupee was highly precarious. The economic consequences of such a policy would have been disastrous. It is very likely that to induce an increasing offer of sterling the yield as well as the volume of Treasury Bills would have had to be increased, so that the volume of the floating debt of the Government of India would have unnecessary swollen, and its cost would have been unnecessarily higher. A grinding process of deflation would have been inevitable through a drastic contraction of credit by raising the Bank Rate and also through contraction of currency. All these consequences would have accentuated the effects of the collapse of the boom of 1936. Industrial enterprise had already suffered a set-back in 1937, and a very slight recovery which was discernible in 1938 would have receded to the background.

We are now in a position to examine how far, in the face of weakening exchange and the consequent stoppage of the purchase of sterling, the Reserve Bank's policy of drawing upon its sterling resources to meet the demand for remittance on Government account, reacted upon the internal value of the rupee.

In the existing abnormal circumstances the Reserve Bank had three ways of obtaining sterling resources :—

(1) It could draw upon the item which is described in the accounts of the Banking Department as *Balances Held Abroad;* (2) when the balances held abroad were insufficient, or had already fallen to a dangerously low level, it could draw upon the sterling assets of the Issue Department after making consequential adjustments (which we shall consider presently); and (3) it could replenish its sterling resources by raising a sterling loan. The third possibility has not been exploited by the Reserve Bank. The practice in past years was to raise additional loans in London to meet maturing obligations, but not a single loan has been raised for repayment purposes in the past four years. In this way, according to the recent Government communique, Rs. 60 crores of sterling debt have been repatriated since 1935-36. It is necessary, however, to examine how far the other two possibilities have been exploited by the Reserve Bank. This question is relevant to the present enquiry, and our conclusions will throw light on the technique of the management of currency and finance which the Reserve Bank has had to evolve in order to meet an abnormal situation for the first time after its inception. The facts bearing on this question are presented in the table (on page 23) compiled from the weekly statements of the affairs of the Reserve Bank.

BALANCES HELD ABROAD AND STERLING SECURITIES.

(In thousands of Rs.)

1938 Week ending.		Reserve Bank's balances held abroad.	Sterling securities held by Reserve Bank.
March	18	9,06,76	78,80,70
,,	25	9,44,05	78,80,70
April	1	7,53,59	78,80,70
,,	8	5,47,26	,,
,,	15	5,33,55	,,
,,	22	4,86,75	,,
,,	29	4,70,81	,,
May	6	4,34,72	,,
,,	13	4,04,06	,,
,,	20	2,05,12	,,
,,	27	1,98,67	78,80,70
June	3	3,24,47	76,14,37
,,	10	3,41,47	,,
,,	17	2,12,55	,,
July	8	1,22,00	72,15,00
,,	15	90,00	72,15,00
,,	22	2,95,00	69,49,00

It is interesting to note that the Reserve Bank's balances held abroad were considerably depleted during the period under review. The sterling balances of the Banking Department diminished from Rs. 9,06,76,000 on the 18th March to as low a figure as Rs. 1,98,67,000 on the 27th May. There was a sudden increase during the following two weeks, so that the sterling balances stood at Rs. 3,41,47,000 on the 10th June. But they dwindled again during subsequent weeks till they reached a very low level of Rs. 90 lakhs on the 15th July. There was again an acquisition of considerable sterling resources, so that the sterling balances reached the figure of Rs. 2,95 lakhs on the 22nd July. These fluctuations in the sterling balances cannot be explained by fluctuations in trade activity at any rate after the stoppage of the purchase of sterling which cut off the Reserve Bank from the general source of supply of sterling represented by the exchange market. How then are we to explain these fluctuations and account for the fact that the Reserve Bank's balances abroad on the 22nd July were only a little less than one-third of what they had been about four months previously?

A most plausible explanation is found in the changes in the total value of sterling securities held as assets of the Issue Department. It seems certain that a fairly large amount of these securities was

transferred to the Banking Department to be utilised for meeting the Government demand for remittance. Apparently, however, the Reserve Bank did not resort to this method of financing sterling remittance up to the 27th May. Between the 18th March and the 27th May although the Reserve Bank's balances held abroad had dwindled from Rs. 9,06,76,000 to Rs. 1,98,67,000, yet the sterling assets of the Issue Department had remained at the same figure of Rs. 78,80,70,000. It was during the week ending the 3rd June that there started the process of drawing upon the sterling assets of the Issue Department. In May the foreign balances had already come down from a little more than Rs. 4 crores to a little above Rs. 2 crores. The *Indian Finance* commented, "Doubtless the fall is due to the payment of half-yearly interest on $4\frac{1}{2}$ p.c. 1950-55 sterling loan". But interest payments amounting in all to Rs. 1·3 Crores on 5 per cent 1942-47, 4 per cent 1948-53, $3\frac{1}{2}$ per cent 1954-59 and $4\frac{1}{2}$ per cent 1958-68 were also due in June. It is obvious that, since sterling balances had already sunk to a low level, the remittance programme could only be met by other means. And it is significant that the sterling assets of the Issue Department were reduced to the extent of Rs. 1,66,33,000 during the week ending the 3rd June, while at the same time the sterling balances of the

Banking Department were augmented to the extent of Rs. 1,25,80,000. The inroads on the sterling assets of the Issue Department have continued unabated since then. But it should be noted that between the 17th June and the 22nd July the depletion of these assets amounted to as much as Rs. 6,65,37,000. The sterling resources of the Banking Department were no doubt considerably replenished at the expense of sterling securities after having fallen to a low figure of Rs. 90 lakhs. But this does not entirely explain such a considerable reduction in the sterling assets of the Issue Department. Hence it may be presumed that the Government of India must have been repartriating their sterling debt to some extent.*

What were the consequential adjustments and reactions incidental to the policy of drawing upon the sterling assets of the Issue Department? The answer that has been given to this question is that all the financial adjustments in the Issue and the Banking Departments of the Reserve Bank have been determined by the inevitable necessity of a deflationary contraction of currency with the object of supporting exchange. Without resorting to *a priori*

---

* In June and July the depletion of sterling reserves amounted to as much as £ 7 million.

reasoning let us look into the facts revealed by the weekly statements issued by the Reserve Bank.

Those who have occasion to study these weekly statements are aware that the assets of the Issue Department are divided into two categories:—

A. which consists of gold coin and bullion (held in India and outside India) and sterling securities.*

B. which consists of rupee coin, Government of India rupee securities,† and internal bills of exchange and other commercial paper.

A corresponds to the cash reserve of a commercial bank, and so the ratio of A to liabilities—*Reserve Ratio* as it is called—indicates the safety of our note-issue. B constitutes the invested portion of the paper currency reserve, and it is natural that the silver rupee, which is actually an inconvertible note printed on silver, should be regarded as an instrument of credit and placed in the

---

* To be not less than 2/5ths of the total amount of assets (under Sec. 2). Of all gold coin and bullion at least 17/20ths are to be held in India.

† Shall not at any time exceed ¼ of the total amount of the assets or fifty crores of rupees, whichever amount is greater, or, with the previous sanction of the Governor-General in Council, such amount plus a sum of ten crores of rupees—Sec. 33 (3).

same category as rupee securities, internal bills of exchange and commercial paper.* On the side of liabilities there are two categories:- (1) Notes held in the Banking Department, and (2) Notes in circulation. Of the total amount of notes issued, that portion which is not in circulation, i.e., either returns from circulation, or is not put into circulation, is transferred to the Banking Department and forms part of the assets or the basis of its credit structure.

It is obvious that the ratio of A to liabilities (Reserve Ratio) *remaining the same*, any decrease in A through the utilisation of sterling securities is bound to bring about a contraction of the total note-issue.† But if the ratio (which is expressed as a percentage) is lowered the deflationary effect of the depletion of sterling reserves is considerably neutralized. It must not be assumed that the ratio has remained unaltered during the difficult times through

* It may be argued that sterling securities also should not come under category A, since the British currency is also off the gold standard. But since sterling is the standard of value of the rupee it has to be given a place of importance along with gold in the category A.

$$\dagger \left.\begin{array}{l}\text{Issue after}\\ \text{change in A}\end{array}\right\} = \begin{array}{c}\text{A as it stands}\\ \text{after change}\end{array} \times \frac{100}{\text{percentage of A to liabilities}}$$

which the Reserve Bank had to pass in recent months.*

Week ending	Ratio of A to liabilities in the Issue Department
March 18	57·73%
April 29	57·39%
May 27	57·19%
June 3	56·58%
July 22	53·61%

* At the time when the gold standard was abandoned by many countries, countries like France and the U. S. A., who were still on the gold standard, and as creditor countries also insisted on repayment of debt in gold rather than in commodities (which would have competed with the products of domestic industries and were therefore unwelcome), authorized their central banks to raise their reserve ratio and thus neutralize the inflationary effect of the inflow of gold. Similarly a deflationary tendency can be counteracted by a lowering of the reserve ratio. In this connection it is interesting to note that on the 6th January, 1939 gold worth £ 350 million (at the current price) was transferred from the Issue Department of the Bank of England to Exchange Equalisation Account for supporting exchange. In order to neutralize the effect of the gold transfer the British Government intended to amend the Currency and Bank Notes Act of 1928 so as to provide for a simultaneous increase in the fiduciary note-issue from £230 millions to £400 millions.

There is clear evidence to show that during the period under review apart from minor fluctuations the ratio has definitely shown a falling tendency. For our present purpose, however, let us compare the reserve ratio as it stood on the 27th May (after which the process of drawing upon the sterling securities of the Issue Department started) with the ratio as it stood on the 22nd July, and find out the implication of a diminished ratio.

Week ending.		Total Note-issue	Percentage of A to note-issue	A
May 27	....	215,45,62 (thousand Rs.)	57.19	123,22,21 (thousand Rs.)
July 22	....	212,45,00 (thousand Rs,)	53.61	113,90,00 (thousand Rs.)

If the percentage of A to note-issue had remained the same, viz,, 57.19, the total note-issue on the 22nd July would have been

$$113{,}90{,}00 \times \frac{100}{57 \cdot 19} = 199{,}16{,}07 \text{ (thousand Rs.)}$$

Hence it is obvious that through the lowering of the percentage of A to note-issue, contraction of paper currency to the extent of Rs. 13,28,93,000 was obviated. In view of the fact that under Section 33 (2) of the Reserve Bank Act of 1934 "of the total amount of the assets, *no less than two-fifths* shall consist of gold coin, gold bullion or sterling

securities"*, it is easy to see that the limit up to which sterling resources could be utilised without any deflationary effect on currency was by no means reached.†

In this connection it is necessary to consider a suggestion frequently made by the *Indian Finance* of Calcutta for meeting the existing situation without any deflationary adjustment, viz, that the sterling securities should have been *replaced* by *ad hoc* rupee securities of the Government of India. It commented on the 30th July that "one cannot understand the reluctance of the authorities to create *ad hoc* securities to the extent of the withdrawal of sterling securities"‡. What is the essence of the plan suggested here? It should be remembered that, although sterling securities and the Government of India rupee securities are both parts of the assets of the Issue Department, yet they belong to different categories. Replacement of the former by the

* This means that the ratio of A to liabilities must be at least 40 p. c.

† In extreme emergency even a part of the gold stock can be utilised, because the gold holdings on the 22nd July amounted to Rs. 44,12 lakhs, whereas the minimum prescribed by the Reserve Bank Act is Rs. 40 crores—See 33 (2).

‡ See also *Indian Finance*, April 23, 1938.

latter would mean an addition to B or the invested portion of the assets and not to A. Hence the percentage of A to liabilities would be lowered, although the total value of the assets remains constant. Obviously, therefore, this plan really amounts to what has been adopted in practice, viz., counteracting deflationary contraction of currency by lowering the percentage of A to liabilities.*

We shall next discuss the extent and nature of actual currency contraction for which the Reserve Bank may be held responsible. For some time past enlightened opinion in India has taken a very grave

---

* The point can be illustrated by a concrete example. The total note-issue on the 22nd July 1938 was Rs. 212,45 crores as compared to Rs. 210,76 crores on the 23rd July 1937. Changes on the assets side are significant. Sterling securities declined from Rs. 80,31 crores to Rs. 69,49 crores, i.e., by Rs. 10,82 crores. Gold coin and bullion remaining the same, A portion of the assets was, therefore, reduced by Rs. 10,82 crores. As the total note issue actually increased by Rs. 1,69 crores the percentage of A to note-issue was thus reduced fram 59·177 to 53·613. B portion of the assets increased *pari passu.* Rupee coin increased by Rs. 7,52 crores and rupee securities by Rs. 5 crores to compensate for the increase in note-issue and for the decrease in sterling securities.

view of the phenomenal shrinkage in the amount of paper currency in circulation. Between the 30th April, 1937 and the 22nd July, 1938 the volume of notes in active circulation declined by as much as Rs. 19,36 crores. This has been regarded as an evidence of drastic deflation which, in the opinion of many, has been bolstering up an overvalued rupee and has a long history behind it. But, on the other hand, during this period the total issue has not only not decreased but has actually increased from Rs. 207,81 crores to Rs. 212,45 crores. What is the significance of these tendencies ? How are we to explain the disparity between the changes in the total note issue and the changes in the active circulation of notes ? What is the relation between the former and the latter ?

We shall discuss this complex question with special reference to the dynamic factors of the existing situation which we have been analysing so far. We have shown that the withdrawal of sterling securities from the assets of the Issue Department has necessarily caused contraction of the total note-issue, although such contraction has not been as it should otherwise have been if the percentage of A to liabilities had not been lowered. Now, *other things being equal*, contraction of the total note-issue should also cause proportionate contraction of

notes in active circulation. If, however, other things which determine active circulation are not equal there will be disparity between the changes in the amount of notes in active circulation and the changes in the total note-issue. For example, while the total note-issue diminishes, the quantity of notes in active circulation may actually increase. To take a concrete instance, during the week ending the 3rd June, 1938 the total note-issue contracted from Rs. 215·46 crores to Rs. 213·05 crores, as the result of the withdrawal of sterling securities to the extent of £ 2 million during this week. But the amount of notes in active circulation *increased* in India from Rs. 172·58 crores to Rs. 173·81 crores and in Burma from Rs. 7·65 crores to Rs. 7·79 crores. The result was, as the returns show, that there was a sharp decline in the notes held in the Banking Department from Rs. 35·23 crores to Rs. 31·45 crores. On the other hand, while the total note-issue decreases at a *given rate* the amount of notes in active circulation may contract to a *much greater extent* owing to other causes, and in this case the amount of notes held in the Banking Department will show a considerable increase. Thus it is clear that the total note-issue and the notes in actual circulation need not vary in the same direction or to the same extent. But it is obvious

TOTAL NOTE-ISSUE AND NOTES IN CIRCULATION.

(In thousands of Rs.)

Week ending		Notes in circulation in India and Burma.	Total Note-issue.
May	20	182,82,12	214,73,63
May	27	180,22,90	215,45,62
June	3	181,60,36	213,05,16
June	10	181,69,56	213,38,29
June	17	178,30,33	214,50,38
July	8	177,97,00	213,23,00
July	15	175,25,00	214,03,00
July	22	173,26,00	212,45,45

that, so far as the effects of currency contraction spread themselves through the economic system, it is the deflationary effect of the contraction of currency in active circulation which is of primary importance. Hence it is necessary to fix our attention particularly on notes in active circulation.

Let us look into the statistics of paper currency relating to the period during which sterling securities were utilised for purposes of remittance. *(See Table on P. 35)* During May, June and July there was considerable contraction of the total note-issue. The decrease of more than Rs. 2 crores between the 27th May and the 3rd June was obviously due to the withdrawal of £ 2 million worth of sterling securities from the Issue Department. There was again a considerable contraction between the 15th July and the 22nd July owing to the withdrawal of sterling securities worth about Rs. 3 crores. But the facts which are more significant in their economic aspects are the uninterrupted fall in the amount of notes in active circulation and the phenomenal shrinkage of this amount* by more than Rs. 9 crores in the course of three months. It is interesting to note that in the present case we find in reality the phenomenon

* This process had been going on for the last fourteen months.

which we mentioned above as a possibility, viz, that the decrease in the amount of the notes in active circulation may be much greater than the contraction in the total note-issue, provided that other things which govern the quantity of notes in actual circulation are not equal. What are the things that were not equal and, therefore, explain this striking disparity ?

This disparity might very well have been the result of currency manipulation. If the object of the currency authorities were to exercise an active deflationary influence on the internal economic structure with a view to maintaining the statutory ratio of 1s. 6d. currency manipulation was inevitable, because to achieve this object it was obviously necessary for them to deliberately contract the currency in active circulation to a much greater extent than would be inevitable in consequence of the withdrawal of sterling securities. The technique of this kind of currency management is not difficult to understand. As already explained, the total notes issued are either put into actual circulation or transferred to the Banking Department of the Reserve Bank. Under Section 23 (2) of the Reserve Bank of India Act "The Issue Department shall not issue bank notes to the Banking Department or to any other person except in exchange for other bank notes or for such coin, bullion, or securities as are permitted by this

Act to form part of the Reserve." Thus notes held in the Banking Department represent an important part of the assets of the Banking Department alternative to coin, bullion, or securities, On the 22nd July they amounted to Rs. 39,19 crores out of the total assets of Rs. 49,67 crores. Whenever this item has to be increased a corresponding sum in "coin, bullion or securities" has to be transferred to the Issue Department in exchange for the additional notes transferred from the Issue Department to the Banking Department. Now if the currency authorities wanted to artificially reduce the amount of the notes in active circulation in pursuance of a deflationary policy, to the extent of such contraction rupee coin, or securities, or both in the 'B' portion of the Reserve will be reduced. But notes to the extent of such contraction may be transferred from the Issue Department to the Banking Department in exchange for a corresponding value in rupee coin, or securities, or both, which will be added to the 'B' portion of the Reserve. As a result of this adjustment there will be neither any change in the *total value* of the assets of both the Issue and the Banking Departments nor any difference in the total note-issue. The only changes will be perhaps an alteration in the *composition* of the assets of the Issue Department, and an acquisition of more notes as assets in the Banking

Department at the expense of rupee coin, or securities, or both. Hence, it is not necessarily unreasonable to suggest the hypothesis that the phenomenal contraction of the notes in actual circulation in May, June, and July, and even earlier was connected with a deflationary manipulation of currency as a corrective of falling exchange.

It is possible, however, to advance another plausible hypothesis which may fit into the facts of the existing situation and explain the phenomenal shrinkage of the paper currency in actual circulation. Was it not possible that the notes had been returning from circulation owing to "a sort of automatic deflation or self-deflation of the economic system (in contradistinction to a deflation imposed on it by the monetary authorities)" which is "just as much an effect as a cause"?* Indeed it may be argued that the tendency to falling exchange and contraction of currency were co-effects of the same fundamental cause, viz., the economic depression, which had been intensified by the collapse of the short-lived boom of 1936, and that the deflationary adjustment of the economic system was being achieved through the medium of falling prices. Since prices had collapsed again as the result of non-monetary causes, the quantity of money in active circulation had been

* Haberler, *Prosperity and Depression* p. 223.

simply adjusting itself to the lower scale of prices. Thus it was essentially 'automatic deflation' which was working itself out; it was not deliberate deflation imposed by the monetary authorities. An argument like this comes very handy to monetary authorities whenever they are accused of mismanaging the currency system of a country. For example, as students of currency history are aware, when prices soared up in different countries during the period of the Great War the monetary authorities were anxious to absolve themselves from blame by trying to prove that the abnormal rise of prices was essentially due to non-monetary causes, particularly the conversion of peace industries into war industries, and that they simply adjusted the supply of currency to the needs of an unprecedented situation. But people still remember how the great Swedish economist, Gustav Cassel dispelled the illusion of 'self-inflation' and proved the existence of deliberate inflation imposed on the economic system by monetary authorities in the different countries of the world. To take another interesting example from the currency history of the United States of America, "there was a disastrous deflation" in the U. S. A. in 1920 as a result of the action of the Federal Reserve Board, as Professor Irving Fisher has demonstrated. But like the

general public the Federal Reserve Board believed "that the high price level of the post-war period was due primarily to a scarcity of goods. When, as a consequence of falling prices, the markets were suddenly flooded with unsaleable goods the Federal Reserve Board in its Annual Report for 1920 explained this phenomenon as being due mainly to non-monetary causes. They said that the year had been one of 'reaction', that the steps taken 'did not produce deflation but checked the expansion which had been proceeding at a dangerous rate'."* It would be instructive to examine the theoretical basis of this kind of argument with special reference to the deflationary contraction usually associated with the Great Depression which has gripped the economic life of the world.

Modern theories of the trade cycle, particularly their latest refinements, have thrown considerable light on the monetary aspects of the depression and the rôle of the monetary authorities in the contraction process. It is not possible in the course of a survey like this to traverse the vast ground covered by modern monetary theory on this fundamental question. But there are certain aspects of this analysis which

---

* Fisher, *Stabilised Money*, pp. 221-224.

must be briefly stressed in the interests of rational economic thinking on Indian currency and exchange.

An economic depression may be viewed essentially as a process of contraction. During the period of expansion or upswing there are serious maladjustments in the structure of production. Hence the depression which follows is held to be "a period of adaptation during which the economic system reverts to equilibrium and eliminates the maladjustments which have developed during the preceding upswing and have been brought to light in the crisis".* This process of readjustment and contraction has a monetary aspect. As it continues its course there is a prolonged decrease in the total demand for goods in terms of money (MV), a process which is broadly described as deflation. Here deflation is not interpreted in the narrow sense of a deliberate policy pursued by a central bank or commercial banks to restrict the supply of currency. Certain writers in emphasising the non-monetary maladjustment in the structure of production go so far as to regard the process of deflation as an accident or at best a "Secondary deflation" which is induced by the non-monetary maladjustment and does not occur independently. Thus it is assumed by them that the

* Haberler, *Prosperity and Depression*, p. 223 f. n.

difficulties arising from the shrinkage in the aggregate flow of money "are super-imposed on the disturbances involved in the necessary readjustment in the structure of production."* But, as Haberler says, "more recent writers have come to realise increasingly that the above view is a misconception, that what it treats as an an accidental phenomenon is in fact the most important element in the depression, that the deflation may continue long after the maladjustment by which it was started has been removed, that it may be started by purely monetary forces without anything being wrong with the structure of production, and that it does not revert directly to equilibrium, but on the contrary carries the economic system a long way away from equilibrium."† In fact without the fact of deflation it is not possible to account for the rapid deterioration of the economic situation throughout the whole field of industry in over-developed as well as under-developed branches of production; nor is it possible to explain the "cumulative and self-reinforcing" character of the economic depression. What are the manifestations of the deflationary process? After the boom has collapsed the banks will not only stop expansion of credit but they will also try to increase the

---

* Op. Cit p. 54.

† Ibid. P. 223 f. n.

liquidity of their assets by contracting credit. "Liquidity preference", to use the expression of Keynes, will increase throughout the whole field of industry and finance. Not only banks but also industrial firms and individual businessmen will desire more liquidity and strengthen their cash reserves. But such a process of general debt liquidation will lead to forced sales of assets, such as securities, real property and commodities, and this will intensify the deflationary pressure. The net effect will be a considerable amount of hoarding. In the case of banks the cash reserves will swell, and their balances with the central bank will increase. Moreover, the disappearance of a large volume of deposits will mean so much less purchasing power in the hands of the public. Hence a considerable amount of purchasing power will be either hoarded and hence sterilized, or will be destroyed altogether. The general fall of prices which occurs acts as a deterrent to investment, and business enterprise is further discouraged by the fall of the rate of profits below the general money rate. The most remarkable consequence of the increase of liquidity preference and hoarding is the extremely low short-term money rate which prevails in the money market in the course of the depression.

Now, what rôle does the central bank of a

country play in the general deflationary process? Active deflation on the part of the central bank is not a necessary concomitant feature of depression. On the other hand, at the early stage of the depression when there is a financial crash there may be actually an increase in note circulation to replace the notes which disappear from industrial circulation at some other point in the economic system owing to hoarding or diminution of the velocity of circulation of money. But very often active deflation appears in the course of the depression as an important intensifying or accelerating factor. When, for example, during the course of the depression there is disequilibrium in the international balance of payments of a country, active deflation becomes inevitable. One is reminded, in this connection, of the position of India's balance of accounts which we analysed above, and one wonders if it was possible for the Reserve Bank to resist considerable active deflation, the effects of which were super-imposed upon the effects of the general contraction process through which India has been passing. Monetary experience in other countries has shown that the desire to protect the currency reserves also leads to active deflation. For example, owing to the enormous increase in gold stocks in France and America—in France to the extent of 964

million dollars and in America to the extent of 847 million dollars—from the beginning of 1929 to the middle of 1931 the central banks of other countries were forced to raise discount rates, i.e., adopt deflationary measures in order to protect their gold reserves. The resulting stringency of credit precipitated the financial crisis and the abondonment of the gold standard in many countries. In India the depletion of the sterling reserves of the Reserve Bank may easily lead to very drastic active deflation. No doubt, as we have shown above, although the percentage of 'A' to liabilities of the Issue Department of the Reserve Bank has gone down recently, yet there is still a considerable margin above the legal minimum. But we should remember that the Reserve Bank is not out of the wood yet, and the present situation does not warrant us to be too optimistic about the near future. The central bank of a country also resorts to 'active' deflation with the ostensible object of stabilizing the internal money market but ends by intensifying the general contraction process! Recent currency history furnishes interesting examples of such currency mismanagement. In America before the Wall Street crash of 1929 the Federal Reserve System took a series of contradictory actions which were "not taken with regard to the business, agricultural or industrial

situation of the country, but with the intention of curbing speculation in the securities markets. Naturally the price level and business conditions were also affected by this new restriction which came just at a period when business was recovering and prices were rising."* As Dr. Fisher points out, there were people who unsuccessfully pleaded with the Federal Reserve authorities not to pay attention to security prices which, in the words of Professor Commons, should have been classed "along with rents, wages and retail prices," and foresaw "the detrimental effect upon the entire country of the deflationary measures applied to curb stock exchange speculation."† Moreover judged by the test of the commodity price index the currency manipulation of the Federal Reserve System (by raising or lowering the re-discount rate and by sale or purchase of Government securities) was slipshod and untimely.‡ When at last the stock market crash came in 1929 and things were heading towards a slippery deflationary incline the Federal Reserve authorities were again advised to control the situation by reducing the rate of discount and purchasing government securities, but they had no definite policy and were

---

* Fisher, *Stablised Money*, p. 251.

† Ibid. p. 255.

‡ Ibid. p. 252.

afraid of inflation and credit expansion with the result that the economic crisis gathered all the momentum of a devastating process of contraction. Thoughtful men in America at that time were convinced that if Governor Strong of the Federal Reserve Board had been alive he would have followed the same energetic policy by which gold inflation was prevented and stabilization achieved between 1923 and 1928. In Great Britain also active deflation prevented British industry, trade and employment from reaping the full advantages of the abandonment of the gold standard in 1931. As soon as the gold standard was abandoned the Bank of England raised the Bank Rate to an extraordinarily high level of 6 p. c. This action was taken ostensibly for preventing the pound from depreciating too much in relation to gold currencies. But, as Hawtrey says, "The 6 per cent rate lasted five months................ By the 18th of February, 1932, when the Bank Rate was reduced, the vicious circle of deflation had been once again joined, and it was as impossible as it had been a year before to induce traders to extend their borrowings by cheap money alone. The opportunity had been lost, deflation and falling prices prevailed in spite of the abandonment of gold, and the pound sterling had become a currency only one degree less intolerable than gold itself. The transition to cheap money,

when it came, was prompt. In four weeks the rate came down from 6 p.c. to 3½ p.c. (17th March 1932). Then by slower stages it was reduced to 2 (June 30th). But it was too late."* One cannot help feeling, after the currency experience in Great Britain and the U. S. A., that the fear of inflation shaped the currency policies of these countries, and that what is essential for correcting disequilibrium is the timeliness of action rather than the methods of currency management. Hawtrey sums up the attitude of monetary authorities correctly when he says that "the real obstacle to measures of credit expansion is not the fear that they will not be effective, but the fear that they will." † In this connection it is necessary to refer to the success of currency management in Australia and Sweden. These two countries abandoned the gold standard and had also to face the problem of currency depreciation. But the central banks of these countries backed by supplementary economic and financial measures were able to pull their weight effectively against the

* Hawtrey, *The Gold Standard in Theory and Practice*, 1933, p. 185. One can realise how much 'the lost opportunity' meant for India when she had linked her currency with sterling at a fixed ratio.

† Hawtrey, *Trade Depression and the Way Out*, 1931, p. 74.

general deflationary process induced by the world economic depression. These currency experiments have their lessons for India, because the currencies of these countries are, in common with the Indian currency, linked to sterling, and also because Australia, being like India a predominantly agricultural country dependent on exports and also burdened with a large amount of external indebtedness, has had to face somewhat similar problems of economic maladjustment during the present depression. The essence of the Swedish experiment was to prevent by skilful currency management a serious depreciation of the external purchasing power of the Krona without creating deflation at home, and also to prevent domestic prices from following the downward course of world prices; while in Australia depreciation of the currency was combined with expansion of credit and the adjustment of the internal cost and debt structure to the lowered purchasing power caused by the general, world-wide deflationary process.

It is necessary to discuss the significance of the easy money policy which was being pursued by the Reserve Bank during the recent crisis. Our analysis has shown that in consistently following a commendable policy of easy money the Reserve Bank was giving a correct lead to the short-term investment

market. We have also pointed out the danger and futility of stiffening up money-rates with the object of supporting exchange. But one should not run away with the idea that the easy money policy of the Reserve Bank, which was indicated by a low rate of re-discount and the low yield on Treasury Bills, was capable of having a reflationary effect under the existing conditions. As Hawtrey has shown, the opportunity for a salutary measure of reflation was lost in England just after she had abandoned the gold standard. The transition to cheap money when it did come was no doubt prompt, and the Bank Rate was reduced gradually from 6 per cent to a mere 2 per cent. But since the vicious circle of deflation which had been broken through going off gold was 'rejoined', an easy money policy was too late and had practically no effect on the economic system. In India also the deflationary currency policy of the Government, which had started much earlier and continued particularly during the early phases of the depression, had the effect of intensifying the pressure of the contraction process which had seized the economic life of the country. The banking policy in harmony with the currency policy also exerted an extremely deflationary pressure on economic activity. Indeed, as the following comparative table of discount rates

shows, the Imperial Bank Rate was much higher than the discount rates prevailing in other countries during the early phase of the depression.

Average Discount Rates of Central Banks.

	India.	United Kingdom.	U.S.A.	France.
1931	7·09	3·93	2·12	2·11
1932	5·03	3·01	2·81	2·5
1933	3·56	2	2·56	2·5
1934	3·50	2	1·55	2·66
1935	3·45	2	1·5	3·38
1936	3	2	1·5	5

After the establishment of the Reserve Bank the Bank Rate came down gradually to 3 per cent and has remained steady at this figure since 1936. The easy money policy has no doubt stabilized the internal capital market to some extent, but has failed to have any effect on the depressed conditions of industry, trade, agriculture and employment, because it came too late to be of any practical consequence. It is interesting to speculate why such a policy unless it is timely becomes futile. When the maladjustment between the cost and debt structure and prices has become very much pronounced, when liquidity preferences have become generally higher, and when there has been already considerable hoarding and destruction of purchasing power, the

contraction process acquires such a cumulative momentum that the easy money policy at this stage becomes powerless to arrest it to any extent. In the case of short-term loans the demand for investible funds during the depression becomes so inelastic over a certain range that a lowering of the interest rate has no effect on the total quantity of capital invested.* In the case of long-term loans liquidity preference being high, even when short-term money is cheap the market shows a reluctance to lend for long periods, so that a large differential appears between the long-term and the short-term rates of interest. In India these symptoms of the collapse of credit are much too evident. In the case of a predominantly agricultural country like India in which the masses of the agricultural population are heavily indebted Dr. Fisher's 'debt-deflation' theory of the business cycle has a special significance. As prices fall the burden of debts becomes heavier, and this leads to distress selling which forces down prices still further. Even in normal times the average peasant in India is not sufficiently credit-worthy. But during the depression the 'effective' money rates have been pushed up much higher owing to what Keynes calls double-counting of risks, which implies that both the debtor and the creditor believe

* The demand curve becomes a vertical straight line.

that each will have to bear the weight of the possible losses. As Haberler explains, " In the course of the deflation the money-value of the wealth of the debtor is likely to diminish, the entire probability curve of returns is reduced, and, in consequence, the range of possible losses which the debtor could not make good increases. The debtor finds that a greater part of risk consists not in the danger of having to sell part of his property in order to pay his debt, but in having to go through bankruptcy courts. The creditor finds that he stands in greater danger of not being able to recover his money. In those circumstances there is a greater likelihood of a double-counting of the risk."* It appears, therefore, that there is so much disequilibrium between the cost and debt structure and prices that the easy money conditions can have no reflationary effect upon economic activity. And since the opposite policy of supporting exchange by stiffening up money-rates was out of the question, it is probable that the currency authorities were falling back upon the device of deflationary contraction of currency for strengthening the shaky basis of the rupee-sterling exchange.

* Haberler, *Prosperity and Depression*. p. 228.

CHAPTER II.

THE RUPEE-STERLING EXCHANGE AND THE OPERATIONS OF THE RESERVE BANK OF INDIA.

(August 1938 to December 1938.)

When we observe the course of the rupee-sterling exchange during the second half of 1938 we are struck by the fact that the corner was turned in July. The average exchange-rate in July, August and September was 1s. 5-7/8d as against 1s. 5-49/64d. in June. But one must remember that the average rate of 1s. 5-7/8d was exactly the same as the average for the month of May, during which the effects of trade recession were still keenly felt, and was much lower than the average for April, viz., 1s. 6-1/32d. Hence, on the whole, there was no appreciable improvement in the position of Indian exchange during these three months. During the first two weeks of August the T. T. rate was in the neighbourhood of 1s. 5-29/32d. which was a little above the monthly average of 1s. 5-7/8. But in the third week the exchange sagged to 1s. 5-7/8, and

there was a collapse during the last week. The exchange position was so vulnerable that, as the result of considerable remittance enquiry in the Bombay market, the exchange sagged during the last week of August from 1s. 5-7/8d on Monday to 1s. 5-27/32d. on Wednesday, to 1s. 5-13/16d on Thursday and to 1s. 5-25/32d. on Friday. From September onwards a distinct change for the better was discernible. There was recovery in the first week of September to 1s. 5-27/32d, and the T. T. rate remained fairly steady at this figure during the second week. During the third week there was a definite rise to 1s. 5-29/32d due to a rise in the bill rate caused by a stiffening of the rate of discount in the London money market. But what is remarkable is that from the middle of September onwards the T. T. rate has been fairly steady at 1s. 5-29/32d with occasional lapses to 1s. 5-7/8d.

When we observe the fluctuations in the purchase of sterling by the Reserve Bank in relation to the trend of the exchange rate we find that during the period under review the Reserve Bank was struggling hard to meet the remittance programme of the Government of India through purchases of sterling in very adverse circumstances.

STERLING PURCHASED BY THE RESERVE BANK.

Week ending	July	29,	1938	....	£ 415,000
"	Aug.	5	"	....	£ 405,000
"	"	12	"	....	£ 255,000
"	"	19	"	....	×
"	"	26	"	....	×
"	Sept.	2	"	....	×
"	"	9	"	....	×
"	"	16	"	....	£ 95,000
"	Oct.	14	"	....	£ 650,000
"	"	21	"	....	£ 680,000
"	"	28	"	....	£ 200,000
"	Nov.	4	"	....	£ 250,000
"	"	11	"	....	£ 400,000
"	"	18	"	....	£ 200,000
"	Dec.	25	"	....	£ 30,000
"	"	2	"	....	£ 430,000

The Bank had lowered the tap rate for the purchase of sterling from 1s. 6-1/32d to 1s. 5-15/16d on the 14th July with the object of getting at least 1s. 5-29/32d. It will be noticed that it succeeded in buying as much as £ 415,000 during the week ending July 29, 1938. Subsequent purchases up to August 12 were considerable, and since during this period the T. T. rate was in the neighbourhood of 1s. 5-29/32d it is probable that the Bank succeeded in realising at least 1s. 5-29/32d as it expected when it had lowered the tap rate. Between August 12 and September 16 no sterling was purchased, apparently because the T. T. rate sagged from 1s. 5-29/32d on the 13th August to 1s. 5-25/32d on the 27th August. Thereafter the T. T. rate improved gradually to 1s. 5-29/32d by the middle of September, and the purchase of sterling was also resumed. The steadiness of the T. T. rate in the neighbourhood of 1s. 5-29/32d after the middle of September apparently enabled the Reserve Bank to purchase fairly large quantities of sterling. But on the whole the situation was not reassuring. For one thing, the Bank seems to have been forced to regard the lowered tap rate of 1s. 5-15/16d as the norm and to have withdrawn from the market whenever the T. T. rate had been lower than 1s. 5-29/32d. For another, up to the 10th of December the Bank

succeeded in purchasing only £ 4,658,000, while the annual requirements are somewhere near £35 millions. During the few months left before the close of the financial year it is difficult for the Bank to fulfil the remittance programme without drawing upon the sterling assets of the Issue Department. And it is significant, as the statement of the Reserve Bank issued on the 2nd December shows, that sterling securities have gone down again from Rs. 62·16 crores to Rs. 60·83 crores, while the weekly statement of the 16th December shows further diminution to a little over Rs. 59½ crores.

After the middle of July gold exports spurted up again and influenced the course of the exchange rate. But they have operated as a fortuitous factor in somewhat strengthening the shaky basis of the rupee-sterling exchange in the same way as they did after the abandonment of the gold standard by England in 1931. The currency authorities have no doubt experienced a much-needed relief, but the intrinsic position of Indian exchange is still vulnerable despite the outflow of gold. In fact, the failure of gold exports in recent months to buttress up the rupee to a sufficiently favourable position points to the inherent weakness of the rupee-sterling exchange. The facts bearing on this question are set forth in the table on page 60.

GOLD EXPORTS AND THE STERLING-DOLLER EXCHANGE.

Date.		Price of gold. Sterling-dollar rate	London (Spot per fine oz) s	d	Bombay (Ready per Tola) Rs.	as.	p.	Exports (Thousand Rs.)	Week ending	
July.	30	4·9 1–23/32	141	6	35	11	9	1,04,90	July	30
Aug.	6	4·89– 3/8	142	1½	35	12	0	79,79	Aug.	6
Aug.	13	4·87– 1/8	142	9	36	0	6	57,73	Aug.	13
Aug.	20	4·87– 11/32	142	5½	35	15	9	4,72	Aug.	20
Sept.	3	4·84– 5/16	143	5	36	4	6	7,65	Sept.	3
Sept.	10	4·81– 5/32	143	4½	36	8	3	801	Sept.	10
Sept.	17	4·80– 1/8	144	2½	36	2	0	3,55	Sept.	17
Oct.	8	4.78– 5/16	145	4½	36	5	0	56,52	Oct.	8
Oct.	15	4·73– 5/8	146	8½	36	10	3	73,37	Oct.	15
Oct.	22	4·75– 13/16	146	1½	36	8	9	62,04	Oct.	22
Oct.	29	4·76– 9/16	145	10½	36	8	0	19	Oct.	29
Nov.	5	4·75– 3/32	146	1	36	8	0	5,44	Nov.	5
Nov.	12	4·73– 25/32	146	9	36	10	6	22,23½	Nov.	12
Nov.	19	4·70– 1/16	147	11½	37	0	9	31,03	Nov	19
Nov.	26	4·62– 7/8	150	0	37	8	6	9,50	Nov.	26
Dec.	3	4·68– 9/16	148	5	37	4	9	×	Dec.	3

The outflow of gold from India after the middle of July is clearly traceable to the progressive depreciation of sterling in relation to the dollar. As the dollar appreciated in terms of sterling the price of gold quoted in sterling as well as in rupees rose steadily during the period under review, and it was but natural that the gold exports should have once more occupied a place of importance in India's balance on current account. It will be observed that the depreciation of sterling (and the rupee) in terms of dollars and the corresponding rise in the price of gold have been equally sensational. Up to the 20th July the sterling-dollar rate was above the historic parity of 4·86. But on August 30th the rate declined below par, and since then it registered a sensational fall. The historic par of 4·86 had been meaningless. It had been felt by many that fear of inflation and devaluation in America had often kept the dollar undervalued in relation to sterling to the extent of 3 p. c. and more for years. But it was in recent months that the symptoms of such undervaluation were quite apparent. America's export surplus was mounting; her industrial costs were falling, and there was a reduction of at least 7 p. c. in American industrial prices. On the other hand British export prices were rising, and Great Britain's adverse balance on current account was accumulating

in such proportions that, according to a recent forecast, it was likely to be not less than £52 millions during 1938. The non-chalance with which the sterling-dollar rate has been allowed to depreciate by both Great Britain and U. S. A. in spite of the Tripartite Agreement shows how enlightened governments realise the necessity of a dynamic adjustment of the exchange parity rather than an irrational adherence to a historic par which may have become meaningless in the course of time. This ought to be an object lesson to the currency authorities in this country. In any case the depreciation of sterling has eased the situation regarding the rupee-sterling exchange by inducing exports of gold and also by stimulating merchandise exports to some extent. The stability of the T. T. rate at 1s. 5-29/32d. during the last quarter of 1938 and the purchase of sterling by the Reserve Bank in considerable quantities were probably due, to a great extent, to the recent depreciation of sterling in relation to dollar. But there are two facts which can not be contemplated with equanimity. First, the T. T. rate is still much lower than what should constitute a normal position from the point of view of the currency authorities. Secondly, the intrinsic weakness of the basis of the rupee-sterling exchange is further revealed by the fact that in spite of the spurt of gold

exports, between August 12th and September 16th no sterling could be purchased by the Reserve Bank as the exchange had a sagging tendency.*

The policy pursued by the Reserve Bank in the matter of selling Treasury Bills during the second half of 1938 presents a contrast to the policy followed by them previously. After April, 1938 the principle which had been generally followed was that the weekly sales of Treasury Bills should be adjusted to the weekly maturities. But since August, 1938 the sales have been regularly much in excess of maturities, as the following table shows:—

Net Increase in Short-term Liabilities.
(In Lakhs of Rs.)

Aug. 4	....	−50·00
Aug. 11	....	×
Aug. 18	....	+100·00

*In November, 1938, there was a rumour in the Bombay bullion market that the Reserve Bank had been secretly purchasing gold to acquire sterling resources, but since the statements issued by the Reserve Bank did not reveal anything of the kind it was surmised that it was purchasing gold for a third party for rupees and receiving payment in sterling which was being devoted to immediate disbursements in England on behalf of the Government of India.

Net Increase in Short-term Liabilities. (Contd).

(In Lakhs of Rupees.)

Aug. 25	.... +100·00
Sept. 1	.... +134·75
Sept. 8	.... +118·00
Sept. 14	.... +100·00
Sept. 22	.... +190·00
Sept. 29	.... + 16·29
Oct. 6	.... + 1·00
Oct. 14	.... + 50·25
Oct. 20	.... +100·00
Oct. 27	.... +150·00
Nov. 3	.... +150·00
Nov. 10	.... +115·50
Nov. 17	.... +115·00
Nov. 24	.... +168·75
Dec. 1	.... + 53·75
Dec. 8	.... + 10·50

The table on the next page presents the statistics which give an indication of the policy generally pursued by the Reserve Bank in relation to the short-term capital market.

THREE MONTHS' TREASURY BILLS.

(In Lakhs of Rupees.)

Week ending.	Total Sales.	Total tendered.	Average discount on accepted tenders per annum.
			Rs. as. p.
Aug. 2	1,50·00	2,73·00	0–10– 1
Aug. 9	1,50·00	2,70·75	0– 9–10
Aug. 16	2,00·00	2,91·75	0– 9– 8
Aug. 23	2,00·00	2,52·75	0 9– 11
Aug. 30	2,00·00	2,43·00	0– 9–10
Sept. 7	2,00·00	2,37·75	0 11 10
Sept. 14	2,00·00	2,70·50	0 12–11
Sept. 20	2,00·00	2,26·75	1 0– 9
Sept. 27	1,16·25	1,16·25	1 8 3
Oct. 5	2,00·00	2,61·00	1– 6– 5
Oct. 12	2,00·00	3,50·25	1– 5– 1
Oct. 18	2,50·00	4,46·75	1– 5– 3
Oct. 25	3,00·00	4,17·50	1– 5–10
Nov. 2	3,00·00	3,67·00	1– 5– 8
Nov. 3 to 4	....	15·50	1– 4– 0
Nov. 9	2,50·00	3,44·00	1 5–10
Nov. 9 to 14	....	55·00	1– 4 0
Nov. 15	2,50·00	3,19·25	1– 6– 8
Nov. 16 to 22	....	1,18·75	1– 6– 8
Nov. 22	2,50·00	2,81·25	1 7– 9
Nov. 23 to 28	....	3·75	1– 7– 9
Nov. 29	2,50·00	2,65·00	1–10– 4
Dec. 6	2,00·25	2,47·25	1–13– 6

It should be observed that, whereas from the beginning of April to the end of July the weekly sales had been mostly less than Rs. 2 crores, after July the weekly sales were mostly Rs. 2 crores, and after the middle of October exceeded Rs. 2 crores and came up to even Rs. 3 crores. It appears that the excess of sales over maturities was very considerable throughout September, October and November. During these months the Central Government had to meet several heavy liabilities. Redemption of 5½ P. C. 1938-40 bonds entailed Rs. 7¾ Crores. Interest payment on 5 p. c. 1940-43 bonds accounted for Rs. 63 lakhs. Interest payment on 5 p.c. 1944 U. P. Government loan and 1961-66 U. P. Government loan amounted to Rs. 10 lakhs. Sterling liabilities amounting to Rs. 7 crores had also to be met. In the aggregate Rs. 15-1/3 crores were put back to the money market, and it was reasonable that there should have been fairly heavy sales of Treasury Bills. But what is remarkable is that, in spite of the prevailing dullness of trade, the yield on Treasury Bills showed a gradually rising tendency. Up to the middle of September the average discount on accepted tenders was fairly low in the case of Treasury Bills offered on behalf of the Central Government. But the discount on Bills offered on behalf of the Provincial Governments

was unjustifiably higher. The discount on 6 months' Bills offered in August on behalf of the Madras Government (the first of their kind offered on behalf of a provincial government) was as high as Re. 1-3 as.-11 p., while the discount on Bills offered on behalf of the Government of C. P. and Berar was Re. 1-9 as.-0 p. Later in September the discount on 6 months' Bills offered on behalf of the Government of Assam was as high as Re. 1-12 as. 5p. The Reserve Bank should not have allowed the discount rate to rise above 1 p. c. at least in the case of Treasury Bills sold on behalf of Madras and C. P. and Berar in August. After the middle of August there was a sharp rise in the yield on Treasury Bills of the Central Government. This was undoubtedly due to heavy sales. But another contributory factor was the hardening in London discounts to $1\frac{3}{8}$ to $1\frac{1}{2}$ p. c. for three months, as the result of which Exchange Banks began to rely more on investment in London and less on subscription to rupee Bills. The offer of the Madras Government 1953 loan for Rs $1\frac{1}{2}$ crores of which Rs. 110 lakhs was open to public subscription also contributed to monetary stringency. But on the whole, as the *Indian Finance* of Calcutta commented, "unseasonal stringency" was unfortunately allowed to develop in September which is the

slackest month of the year, owing to the high yield on Treasury Bills and the rise in the inter-bank call rate. In November the Reserve Bank very wisely sold 'Intermediates' which fetch 1¼ p. c. and are, therefore, welcomed by banks receiving 3 months' deposits at 1 p. c. But towards the end of November and the beginning of December the yield on Treasury Bills rose to abnormally high levels, and a rise of about 6 annas in the course of a fortnight was indeed phenomenal. The continued monetary stringency, which is reflected in the recent Treasury Bills operations of the Reserve Bank, has undoubtedly contributed to the steadiness of the Ready rate of the rupee-sterling exchange at 1s. 5-29/32d.

Let us now turn to the extent of the withdrawal of sterling securities from the assets of the Issue Department of the Reserve Bank during the period under review. As already said, up to the end of July owing to the meagre sterling purchases (due to sagging exchange) the sterling balances of the Banking Department had suffered diminution from over Rs. 9 crores in March to about barely Rs. 2 crores by the end of May. As the result of the withdrawal of sterling securities held in the Issue Department the balances had been augmented from time to time till by the end of July they amounted to Rs. 3,46 Lakhs. As the following Table shows,

the process of dissipation of sterling resources of the Issue Department and the process of shrinkage of the Reserve Bank's balances held abroad continued unabated during the second half of 1938.

BALANCES HELD ABROAD AND STERLING SECURITIES.

(In Lakhs of Rs.)

Week ending.	Reserve Bank's balances held abroad.	Sterling securities.
July 29	3,46	69,49
Aug. 5	3,27	69,49
Aug. 12	3,39	69,49
Aug. 19	2,52	69,49
Aug. 26	2,44	69,49
Sept. 2	2,08	69,49
Sept. 9	2,01	69,49
Sept. 16	1,37	69,49
Sept. 30	4,65	65,49
Oct. 7	1,93	62,16
Oct. 14	2,41	62,16
Oct. 21	2,75	62,16
Oct. 28	2,94	62,16
Nov. 4	2,52	62,16
Nov. 11	2,22	62,16
Nov. 18	33	62,16
Nov. 25	34	62,16
Dec. 2	33	60,83
Dec. 16	50·6	59,50

The sterling balances shrank steadily from Rs. 346 lakhs on the 29th July to barely Rs. 1,37 lakhs on the 16th September. But there was a substantial addition to the balances between the 16th September and the 30th September with the result that they stood at Rs. 4,65 lakhs on the latter date. At the same time during this fortnight the sterling securities in the Issue Department were reduced from Rs. 69,49 lakhs, at which they had stood since the 22nd July, to Rs. 65,49 lakhs. It may be recalled that after a break of about a month sterling purchases were resumed during the week ending in September 16. But even if we presume that the increase in the sterling balances of the Banking Department was brought about only through the utilization of sterling securities it appears that, while the total value of sterling securities held in the Issue Department was reduced by Rs. 4,00 lakhs between the 16th and the 30th of September, the sterling balances increased only by Rs. 2,28 lakhs during this fortnight. Hence it is probable that repatriation of sterling debt was undertaken to some extent, as the Government have maintained in their communiquè. The decrease in sterling balances to the extent of Rs. 2,72 lakhs and the decrease in sterling securities to the extent of Rs. 3,33 lakhs in the first week of October point to heavy liquidation of sterling resources occasioned

either by the exigencies of the remittance programme, or by the repatriation of sterling debt, or both. Between the 7th October and the 11th November there was no further depletion of sterling securities, while the sterling balances also were at a higher level most probably owing to the extraordinarily heavy weekly purchases of sterling during this period. But after the 11th November the sterling balances of the Banking Department sank to an abnormally low level of barely about Rs. 34 lakhs. At the same time sterling securities went down by Rs. 1,33 lakhs between the 18th November and the 2nd December. Between the 2nd December and the 16th December the sterling balances increased by about Rs. 17 lakhs, but the sterling securities diminished again by Rs. 1,33 lakhs. The abnormal shrinkage in the sterling balances and further inroads on sterling securities in spite of fairly heavy purchases of sterling undoubtedly indicate a highly strained financial situation against which the Reserve Bank has been struggling.

We shall consider next the effect of the depletion of the sterling assets of the Issue Department upon the position of the note-issue during the period under review. We have already explained how the deflationary effect of the depletion of the sterling reserve of the Issue Department was neutralized to some extent by the lowering of the ratio

of A to liabilities by a little more than 4 p.c. between the 18th March and the 22nd July. Moreover we have also pointed out (as the Government maintain in their communiquè) that, in so far as according to the Reserve Bank Act the minimum ratio of A to liabilities must be 40 p. c., there was a big margin up to which the sterling securities might be utilised without any deflationary effect on the total note-issue. It is interesting to note in the Table given below a further lowering of the ratio of A to liabilities in the Issue Department during the period under review. It appears that during the last five months of 1938 the ratio has gone down gradually to the extent of about 3 p. c. This means that there is still a margin of about 9½ p. c. above the statutory minimum.

Ratio of A to Liabilities.

Week ending:			Ratio of A to liabilities in the Issue Department.
July.	29	....	53·29
Aug.	5	....	53·35
„	12	....	53·30
„	19	....	53·14
„	26	....	52·94
Sept.	2	....	52·91
„	9	....	53·02
„	16	....	52·79
„	30	....	51·71

Oct.	7	....	50·94
„	14	....	50·90
„	21	....	50·86
„	28	....	50·79
Nov.	4	....	50·79
„	11	....	50·79
„	18	....	50·70
„	25	....	50·66
Dec.	2	....	50·41

The following Table incorporates the statistics relating to the fluctuations of the note-issue from the 29th July to the 16th December.

Total Note-Issue and Notes in Circulation.

(In Lakhs of Rs.)

Week ending		Notes in circulation in India and Burma.	Total note-issue
July.	29	171,53	213,33
Aug.	5	174,36	213,50
„	12	175,08	213,69
„	19	173,28	214,33
„	26	171,34	215,12
Sept.	2	174,07	215,27
„	9	175,24	214,82
„	16	175,24	214,82
„	30	175,68	212,53
Oct.	7	178,72	209,18
„	14	177,80	209,35

Oct.	21	177,52	209,35
"	28	177,15	209,82
Nov.	4	179,63	209,83
"	11	180,14	209,82
"	18	178,92	210,19
"	25	178,92	210,34
Dec.	2	180,83	208,77
"	16	183,10	206,97

Up to the 16th September the total note-issue was at a higher level than that reached by the end of July. But obviously as the result of the withdrawal of sterling securities from the assets of the Issue Department to the extent of Rs. 7,33 lakhs between the 16th September and the 7th October the total note-issue during this period was contracted by only Rs. 5,64 lakhs. Between the 18th November and the 16th December there was further depletion of sterling securities to the extent of Rs. 2,66 lakhs. And the total note-issue was contracted by Rs. 3,22 lakhs during this period. It should be noticed that the contraction of the total note-issue between the 16th September and the 7th October was very much less than the phenomenal withdrawal of sterling securities. This disparity clearly shows that the deflationary effect of the depletion of sterling assets was neutralized to a considerable extent by the lowering of the ratio of A to liabilities

in the Issue Department by as much as 1·85 p. c. during this period. But it is interesting to note that while the total note-issue was contracted considerably on several occasions during the latter half of 1938, the volume of notes in circulation in India and Burma has not only not been contracted but has, on the whole, shown a tendency to increase. Such a tendency must be contrasted with the tendency to the phenomenal contraction of notes in active circulation during May, June and July.

The review of Indian exchange during the second half of 1938 will not be complete unless we take stock of the state of trade which is the determining factor of the foreign exchanges. The active balance of trade (British India and Burma together) in merchandise showed an upward tendency from June onwards as the following table shows :—

Balance of Trade (British India and Burma).

(In lakhs of Rs.)

	1937 – 38	1938—39
June.	+646	+277
July.	+534	+546
August.	+442	+485
September	+621	+639
October	+325	+358

It is reasonable to suppose that the increase in the active balance of trade and the spurt of gold

exports due to the depreciation of sterling in relation to the dollar have contributed to strengthen the basis of the rupee-sterling exchange. In fact the exchange did turn the corner in June, and from the middle of September onwards a change for the better was clearly discernible. But, as our analysis has shown, the situation is not such as to inspire confidence in the future, and the Reserve Bank does not seem to be out of the wood yet. It has been pointed out in the government communiqué—and the fact is confirmed by statistics given above—that after June the balance of trade in merchandise was in every month in favour of India and to an extent greater than in the corresponding month of the previous year. Even when we take into account the balance of transactions in treasure the total visible balance of trade after June would no doubt compare favourably with that in the corresponding months after June in 1937-38. But it must be remembered that the boom of 1936 collapsed in April, 1937. The price level which had attained a maximum in April, 1937 fell rapidly till June, and declined again sharply and continuously from September to the end of November. After a temporary rally it continued its downward trend, though not so sharply, till the middle of June, 1938. So far as agricultural prices are concerned it was

only in the middle of 1936 that the prices of primary commodities had begun their definite upward movement since the onset of the depression in 1929. As the year advanced the rise almost became a boom, and prices touched a figure that was the highest for many years. But these boom conditions were too artificial to last, and April 1937 witnessed a sudden reversal of the upward movement. Hence the comparable period, from June 1937, to October 1937, was one of sudden and disastrous collapse of prices in general and of agricultural prices in particular, and the magnitude of the decline was clearly seen only after the middle of 1937. It is not very reassuring to contemplate, therefore, that the state of trade was more favourable during this period of 1938 than in the corresponding period of 1937. The fact seems to be that although since the middle of June, 1938 the trend of prices was decidedly upwards, yet it is not still possible to decide whether that month will mark a real turn in the cycle of prices and business activity. Recently the financial experts of the League of Nations expressed the hope that the present crisis is "likely to be more easily overcome than in 1929, because there is no serious credit inflation, and because both short-term foreign indebtedness and world stocks of raw materials are far smaller and the possibilities of credit expansion are

greater."* But at the moment there are certain factors in the economic life of European countries which may rather intensify the deflationary process and prolong the period of economic strain. The most important factor that has been discouraging enterprize is heavy taxation. "The British income-tax rose from 5s. in April 1937 to 5s. 6d. in April, 1938. Save during the period of very high inflation just after the war this country has never before borne such burdens in peace time. In France the effort recently made to staliblize the franc and restore budget solvency has entailed similar sacrifices. In Germany the proportionate load is perhaps greatest of all; and it has just been enhanced by the raising of the very important tax on corporate incomes from 30 p. c. to 35 p. c. for this year and 40 p. c. for next year and the year after."† The second factor which did not exist in 1929 but which is likely to be a fresh cause of economic maladjustment is the present pace of rearmament. Professor Lionel Robbins thinks that "rearmament expenditure is acting to some extent as an anti-cyclical influence." He argues that the "maintenance of the national income is some support to world money income," and that "at the moment this function is being

* *The Spectator*, July 15, 1938.

† Ibid. p. 253.

performed by rearmament borrowing." * But he must be aware that the economic stimulus induced by rearmament borrowing and expenditure has an unsound basis. The expansion of armament industries creates a distortion and maladjustment of the structure of production and prices which deters sound productive enterprize and produces a psychological atmosphere favourable to a down-turn in the trade cycle. Moreover, as a writer in the *Spectator* recently pointed out, although there was an armament race before the Great War, yet the prospects of trade were much less gloomy then than at the present time owing to three great differences. " First, the whole scale of armaments was much smaller—our (England's) highest income-tax rate was 1s. 3d.; secondly, the world had not then experienced the denouement. And thirdly, war was not received in a totalitarian light; nor was the word 'autarky' on the lips of statesmen."† In the communiquè issued by the Government of India emphasis is laid on the fact that since June last the trend of the price-index of the chief articles of export has been definitely upward. In recent months the situation as regards the prices of primary products has been no doubt

* *The Spectator*, Financial Supplement. July 22, 1938.

† *The Spectator*, August 12, 1938.

eased to some extent by the efforts of European nations to build up a war stock. But "that exceptional demand cannot continue permanently. Either appeasement or financial stringency must curtail it."* Industrial production has also slightly increased in countries where there was a downward movement in the earlier part of 1938. But, according to the League of Nations' survey of world trade, the slow but persistent fall of wholesale prices has continued in most countries during recent months. On the whole it is short-sighted self-complacency to make much of the slight improvement in our active balance of trade which may prove to be nothing but a temporary rally in the course of a world-wide deflationary movement which the financial experts of the League described as a serious world economic crisis.†

---

* *The Spectator*. Banking and Insurance Supplement, July 22, 1938. An article by J. D. Marvin, "*Have commodity prices turned the corner?*"

† The trade returns of October show that India's foreign trade position deteriorated in October and the large exports of gold maintained the Balance of Payments as a whole.

CHAPTER III.

DEVALUATION OF THE RUPEE— THE PROBLEM AND ITS SETTING

We emphasized almost at the very outset that devaluation as an immediate economic issue has wider bearings and must be visualized in a broader perspective. Clear and rational thinking on this issue is impossible unless we look upon this problem in the wider perspective of currency stabilization sought to be achieved in India during the post-war period. The present controversy has its roots in the past. There is a general feeling that the Government of India sowed the wind before the depression began, and the country has been reaping the whirlwind since then. It is argued that the rupee had been internally overvalued in 1926 (according to some much earlier), and since then the Indian economic life had to pass through a process of devastating deflation which initiated the economic depression in 1929, or at least the effects of which were super-imposed upon the effects of the world economic depression. Hence the demand for devaluation is nothing but a modest demand for correcting the internal overvaluation of the rupee, a persistent cause of economic dis-

equilibrium. On the other hand the currency authorities hold that since the rupee had already been stabilized in 1926 after careful revaluation the present ratio should be respected as a basic norm which should not be disturbed by "monkeying with the ratio". A controversy like this can not be properly understood unless we examine the rationàle of the post-war stabilization of the rupee.

There is a general consensus of opinion amongst economists on what constitutes the *sine qua non* of monetary stabilization. It is generally agreed that the value of the currency unit of a country should be such as to maintain equilibrium not only in the internal economic structure but also in the balance of its international transactions. The criterion of international equilibrium (from which a country depending largely upon its foreign trade for solvency should not depart) is the "absence of persistent gold movements and of abnormal capital movements motivated by an anticipation of a fall or rise in the exchange rate."* An important dynamic factor which tends to upset the balance of international transactions in relation to a certain country is a fundamental change in the barter terms of trade which affects the external value of a

* Haberler, *Prosperity and Depression*. p. 334.

country's currency. If such a change is not somehow counteracted, or if the so-called normal parity of exchange is not adjusted to the altered terms of trade an artificial pegging of exchange at a particular level becomes disastrous in its effects on internal as well as external economic equilibrium. From the point of view of the internal economic structure stabilization involves a balance between the cost and debt structure and prices and between export prices and other prices.

A point which is very often missed by those who take part in the ratio controversy is that under a system of pegged exchange no parity of exchange should be regarded as representing a so-called 'natural' level or norm which is sacrosanct. Any student of the history of Indian currency knows that the pre-war exchange rate of Is-4d to the rupee was entirely the product of accidental circumstances when it first established itself and was thereafter deliberately maintained at that level by currency management. The present ratio is in a sense as artificial as the ratio of Is.-4d., since it has been, and has to be, maintained by artificial means under a system of exchange standard. Hence it is irrational to be sticklers for any particular ratio under the delusion that somehow it represents a norm. Any ratio which is conducive to, and

consistent with, comparative economic stability under particular circumstances should be the objective of monetary policy. In any case what the norm is should be an open question, for exchange stability must needs be a means to economic stability as defined above, and not an end in itself which may be pursued irrespective of the fundamental maladjustments of our economic life in recent years. During the present economic depression most of the cherished norms of political and economic life all the world over have radically changed owing to revolutionary maladjustments in political and economic life * If, therefore, Indians ask the Government of India to review the question of the rupee ratio and decide what the norm should be in the present circumstances they should not be accused of the childish desire of "monkeying with the ratio," specially when Indians know to their cost that during recent years it is the rupee which has been playing strange monkey tricks with them.

In reviewing the rationàle of post-war currency stabilization attempted in India at the very outset one is irresistibly reminded of the Government of India's misadventure (we refrain from calling it

---

* For example, 'free trade' and 'gold standard' which were so long almost the unalterable norms of British economic life have recently ceased to be so!

'monkeying') with the rupee ratio in 1920. We have already referred to what Professor Fisher has aptly called the 'disastrous deflation' of 1920 in United States of America which the Federal Reserve authorities tried to explain away as a phenomenon caused by non-monetary factors. The deliberate deflation in America led to deflation in other countries which were anxious to prevent the depreciation of their currencies in terms of dollar. In this way a general process of deflationary contraction was initiated in March 1920 after the short-lived post-war boom. In India the currency authorities had blundered into overvaluing the rupee at 2s. (gold). The rate had eventually to be abandoned, because internal prices could not be made to fall to the same extent as external prices. But in the heroic effort to maintain the new 'norm' they had resorted to disastrous deflation, which continued till Indian exchange was left to find its own level and moved in sympathy with the steadily falling internal and external prices.* The result of heavy price deflation was that industrial development, which had started in India during the war and was well under way during the post-war boom, received a set-back. Particularly the protective effects of the raising of

* The process of artificial contraction of currency continued up to August, 1923.

the general tariff from 7½ to 11 p. c. in March 1921, and to 15 p. c. in March 1922 and of the raising of the tariff on luxury goods from 20 p. c., to 30 p. c. were obscured by the general effects of the trade depression caused by world-wide deflation. But it must be said to the credit of the currency authorities that by allowing the exchange rate to find its own level they protected the internal economic structure to a certain extent against the fluctuations in gold prices during the boom of 1919 and 1920 and the slump of 1921 and 1922. From 1922-23 onwards the parity of the relative levels of internal prices in India and in countries which were the best customers of India created an impression that Indian exchange was moving to a position of stability. In 1922-23 the price levels in the United Kingdom and India remained remarkably constant. In Japan also the price level was well maintained. But in America it registered a slight rise. Between 1923-24 and 1925-26 the wholesale prices in U.S.A., Japan and United Kingdom continued to be relatively stable. In 1925-26 the comparative values of Indian exports and imports also were almost back to their pre-war relationship. Exchange was also stable at 1s.-6d. throughout the year. And the picture of stability in the eyes of the currency authorities was completed by the price indices in India, America and United

Kingdom converging towards the same level. Eventually the rupee exchange was stabilized at 1s. 6d. in 1927.

But did the pegging of exchange at 1s.-6d. really give us stabilized money? Were the simple criteria of economic equilibrium carefully applied to the existing situation? In the first place, the stability of the exchange-rate throughout 1925-26 was not necessarily a sign of economic stability. Under an exchange standard it was easy to bolster up the exchange rate and maintain it at a certain level by currency manipulation. The grinding process of deflation which had started much earlier made this task easier, and since the middle of 1924 the pace of further deflation was set by England. What happened was that in England currency authorities had recourse to active deflation for going back to the pre-war gold parity. In June 1924 the pound sterling was about 12 p. c. below the pre-war gold parity. As the result of deflation the sterling price index fell by about 9 p. c. between June 1924 and February 1926. We observe a similar phenomenon of drastic deflation in India where also the wholesale price index fell by 11 p. c. during the same period and the rupee-sterling exchange rose from 1s.-4d. to 1s.-6d., registering a rise of 12½ p.c. Secondly, comparative stability of the

internal price level is nowadays no longer regarded as the only adequate criterion of economic stability. In U. S. A. just before the financial crisis which led to the Great Depression the index of wholesale prices was remarkably steady, but the steadiness of the index masked the inherent economic disequilibrium which subsequently caused a world-wide depression. The price level alone is never an adequate guide for the determination of the policy regulating the currency and credit of a country. Speaking of credit policy, Governor Strong of the New York Federal Reserve Bank, one of the greatest bankers that America has produced, said, "Just as credit is one of the influences upon the price level so the price level should be one of the influences in guiding a credit policy," and he suggested a few considerations which a central bank must have in view in determining a particular policy: "Is labour fully employed? Are stocks of goods increasing or decreasing? Is production to the country's capacity? Are transportation facilities fully taxed? Is speculation creeping into productive and distributive processes? Are orders and repeat orders being booked much ahead? Are bills being promptly paid? Are people spending wastefully? Is credit expanding? Are market

rates above or below Reserve Bank rates?"* As a matter of fact in Sweden the Riksbank consults not only the wholesale price index but also the basic consumption Index (cost of living index) and other available indices such as those of production, trade and employment. Did the currency authorities in this country give sufficient weight to considerations such as these before they decided upon the revaluation of the rupee? Were they sure that internal prices which were suddenly deflated after the currency debaclè of 1920 had been adjusted to wages and other money incomes, to debts and fixed charges of the agriculturists and to the various other elements of cost of production which can not be quickly readjusted? Did they take into account the obvious fact that owing to the vast size of the country and the absence of sufficient economic mobility the process of costs-prices equilibrium ought to take a much longer time to be completed in India than in other industrial countries? Did they make allowance for the necessary time lag? Thirdly, the mere fact that the indices of wholesale prices in United Kingdom, America and India had converged to the same level (160) did not deserve the significance which was

---

* *Interpretations of Federal Reserve Policy in the speeches and writings of Benjamin Strong*, New York, 1930, p. 233.

attached to it. Since the dynamics of the price movements in these three countries were not the same the price indices reaching a particular figure in the course of varying fluctuations did not really mean that conditions were necessarily favourable to international equilibrium, or that Indian prices had been brought into harmony with the national price levels of countries which were the most important customers of India. In fact subsequent tendencies provide the clearest refutation of such confused reasoning. Between 1924 and 1929 the British Board of Trade index registered a fall of over 17 p.c., and the Calcutta index similarly showed a fall of over 18 p. c. Such a parallel movement is explained by the common policy of deflation consequent on the overvaluation of sterling in relation to gold since 1925. But in U. S. A. the index of the Bureau of Trade Statistics fell by only 3 p.c., while the index number of wholesale prices both in Germany and France remained steady during the same period. The fact is that the general movement for international monetary stabilization in 1924 had an unsound basis. As Sir Walter Layton said in 1933, "The mistake that we made in 1924 was to endeavour to set up an international monetary system without first making sure that the economic background was right." Moreover it is necessary to emphasize in this connection

that "measurements of purchasing-power parity based on comparisons of price levels or of changes in price levels in two countries afford only very rough and unreliable criteria of overvaluation or undervaluation of a country's currency."*

A most important dynamic factor which has threatened the equilibrium of India's balance of international payments in recent years, but which has been ignored by the authorities responsible for post-war monetary stabilization in India, is the fundamental change in the barter terms of trade. In official statistical publications the index numbers of external prices of imports and exports respectively in the case of different countries are available for a series of post-war years. If the import price index is expressed as a percentage of the export price index the 'price-ratio' thus obtained is a fairly good index of the terms on which a country obtains its imports in exchange for its exports. In the case of countries importing mainly raw materials and foodstuffs and exporting mainly manufactured goods, the lower the percentage figure the greater the advantage derived by them from selling manufactured products and *vice versa*. On the other hand, in the case of predominantly agricultural countries importing manufactures and exporting raw

* Haberler, *Prosperity and Depression*, p. 334 f. n.

materials and foodstuffs, the lower the percentage figure the greater the advantage derived by them from selling raw materials and foodstuffs, and *vice versa*. In order to bring out the contrast between the predominantly agricultural and the predominantly industrial countries we give below the post-war price-ratios in the case of four countries, United Kingdom, India, Argentine and New Zealand, and we propose to discuss the nature of the change in the terms of trade, its bearing on the balance of international transactions and its repercussion on the external values of the currencies of agricultural countries in general and of the Indian currency in particular.

Price Ratio Indices.

Year.	United Kingdom.	India.	Argentine.	New Zealand.
1920	79	170	127	136
1921	70	164	157	131
1922	76	120	161	146
1923	75	131	151	108
1924	82	116	136	92
1925	84	103	116	87
1926	82	112	136	104

It is significant that the movement of the price-ratio index in the case of agricultural countries has been generally inverse to that in the case of industrial countries like the United Kingdom. During the

early post-war years owing to the greater increase in the prices of manufactured products than in those of raw materials and foodstuffs the advantage as regards the terms of trade had been on the side of industrial countries. But between 1920 and 1925 the import and export price indices of states buying mainly manufactured goods and selling raw materials and foodstuffs were gradually approaching each other. The result was that "in India there was a rapid fall in the price ratio index between 1921 and 1925, and in Argentine and New Zealand, whose products are of a different order, between 1922 and 1925."* On the other hand there was a rise in the price ratio index in the case of the United Kingdom; this meant that the advantage as regards the terms of trade gained by industrial countries was tending to disappear. But the most significant fact to be noticed is that in all the three agricultural countries there was a reaction in 1926, and the tendency was reversed to the disadvantage of agricultural countries in the very year that the rupee was stabilized at 1s.6d!

It would be a mistake to suppose that the reversal of this tendency simultaneously in the three

---

* *Memorandum on the Balance of Trade and International Payments*, 1913-27 (League of Nations) p.p. 34-35 and p. 8.

agricultural countries was a chance coincidence. It is not necessary here to explain in detail the revolutionary changes in world agriculture during the period of post-war reconstruction. But there was undoubtedly one factor which was turning the terms of trade against agricultural countries, viz, the extraordinary increase in the production of foodstuffs and raw materials. It appears from the Memorandum on world trade published by the League of Nations in 1928 that the world's output of cereals and other food crops was 16 per cent higher in 1928 than in 1913, and that the corresponding increases for all foodstuffs and raw materials were 17 p. c. and 48 p.c. respectively. These increases considerably outstripped the rate of increase of the world's population. Mr. T. W. Lamont in his address delivered before the New York Academy of Political Science, also pointed out that the average annual rate of increase of production during the period 1923-1928 was 0·8 p.c. in the case of cotton, 5·8 p.c. in the case of sugar, 6·5 p. c. in the case of rubber, 5·6 p.c. in the case of copper, 5·1 p.c. in the case of crude petroleum, and 4·9 p.c. in the case of pig iron.

It would be instructive to examine more carefully the movements of the indices of export and import prices with particular reference to India.

Price Ratio Indices (India.)

Year	Index of export prices.	Index of import prices.	Price ratio index.	Balance of trade (crores.)
1919-20	158	206	130	+100
1920-21	140	237	170	+ 33
1921-22	127	214	164	+ 55
1922-23	140	169	120	+110
1923-24	145	190	131	+140
1924-25	154	180	116	+151
1925-26	152	158	103	+158
1926-27	132	148	112	+ 86

As already said, between 1920 and 1925 the export and import price indices in the case of India were gradually approaching each other with the result that she was getting gradually better terms for her exports of raw materials and foodstuffs. In 1925-26 the disparity between export and import prices almost disappeared, and the terms of trade as indicated by the price ratio almost reached the pre-war (1913-14) level. It is also significant that as the disparity became less and less the active balance of trade increased; in fact we discover a *close negative correlation between the price-ratios and the active balance of trade.* All these tendencies apparently reflected a movement towards external equilibrium. But the fundamental change in the

structure of world agriculture which had led to a phenomenal expansion of production during the post-war period, and had been threatening the economic position of agricultural countries in relation to industrial countries in the sphere of international trade, was a factor of grave economic maladjustment that did not receive the attention it deserved. It is very clear from the table given above that the export prices began to fall after 1924-25. In 1926-27 the index of export prices was 132 as compared to 152 in the previous year. In the *Review of the Trade of India* we find an official explanation that " the most important factor that contributed to this decrease was the *heavy fall* in the world prices of raw materials, particularly of cotton and jute." But unfortunately the fall in export prices was not viewed in the wider perspective of the causes which were threatening the external equilibrium of agricultural countries in relation to industrial countries and undermining the basis of India's active balance of trade (which is essential for debtor countries) and of her newly pegged exchange.

If our analysis of the world agricultural situation and of the position of agricultural countries *vis-a-vis* industrial countries is correct then it appears that conditions were ripe for a depression in world agriculture which was the most striking initial phase

of the Great Depression that followed soon after. In the following years the agricultural depression was intensified by the universal and uninterrupted fall in commodity prices, and the pressure upon agricultural countries continued after the financial crisis of 1931. Since the beginning of 1931, however, the relation between the prices of manufactured products and the prices of primary products was not changing rapidly to the disadvantage of agricultural countries. But there was no definite improvement in the terms of trade either in 1931 or the early part of 1932. "More specially the depreciation of the pound sterling had not the effect upon price relations that might have been expected."* By the middle of 1932 since the centre of gravity of the economic depression shifted from agricultural countries to industrial countries, there was improvement in the terms of trade of agricultural countries. But there was a reaction again after 1932. In the case of non-European agricultural countries the situation was aggravated by the increase in cereal exports (wheat, barley, rye and maize) from eastern to central and western Europe and a corresponding reduction in cereal imports into Europe from other continents. In fact agricultural protectionism and

* *Review of World Trade*, 1931-32 (League of Nations) p. 63.

the growth of inter-European trade in agricultural products were important factors which adversely affected the position of non-European agricultural countries like India in the sphere of international trade.

The deterioration of the terms of trade of agricultural countries adversely affected their external equilibrium and exchange stability. Most of these countries are debtors, and part of their exports, as in the case of India, may be regarded as payments on account of interest and dividends. " In 11 out of 15 typical agricultural countries the total amount spent annually during 1927-1929 on the service of foreign debts and on dividend payments abroad was approximately one-fifth of the average export value. Dividend payment naturally decreases when business is depressed, but the bulk of the payments—for all debtor countries taken together probably two-thirds—represents fixed charges on long or short-term loans. The fall in the average export prices in terms of gold of five typical non-industrial countries between 1929 and 1930 was from 21 to 25 p. c., and between 1928 and 1930 about 30 p. c. (India and New Zealand 27 p.c., China 29 p. c., Uruguay and Argentine 31 p. c.,) corresponding to an increase in the actual burden of

the fixed debt charges of over 40 p. c."* Between 1929 and 1932 the average fall of about 60 p. c. in the export prices of these countries meant a further increase in the real burden of debt payments in terms of gold currencies. Thus the debtor countries were forced to furnish a constantly increasing quantity of goods in order to meet the fixed external obligations. Simultaneously they were compelled to restrict their imports of manufactured products, and such restriction was brought about through a rise in the prices of manufactured goods relatively to those of agricultural products. Initially owing to the glut in the world market for agricultural products they had been unable to maintain the quantum of their exports. But when the quantum of their imports was restricted the demand of industrial countries for foreign raw materials and foodstuffs was also reduced. Hence the quantum of exports of agricultural countries had a tendency to fall. In these circumstances the pressure to maintain the quantum of exports altered the barter terms of trade still more to the disadvantage of agricultural countries. Evidently they were in a vicious circle. As this process went on they found themselves in a serious predicament. Owing to the stoppage of international lending the balance of international transactions could not be

* *Review of World Trade*, 1930.

modified in their favour by foreign loans. The quantum of imports could not be cut down beyond a certain limit. And they were failing to sell their products in quantities and at prices sufficient to meet their fixed obligations and simultaneously to cover their current needs for foreign goods.

These countries attempted to reach external equilibrium generally in two ways, viz., (1) exportation of gold, and (2) devaluation of their currencies. In 1930 a number of debtor countries were forced off the gold standard, while others tried to maintain the values of their currencies by means of exchange control which contracted imports and stimulated exports. In 1931 the abandonment of the gold standard by Great Britain and the consequent depreciation of sterling involved some relaxation of the burden of debt of certain countries. But the adjustment of the trade balances of agricultural countries urgently required an increase in their competitive power, and this was possible through a reduction of the gold prices of their exportable commodities. As between deflation and currency devaluation almost without exception they chose the latter as the best method of maintaining external equilibrium and the stability of the external values of their currencies. But the important question which we must now answer is, what

has been India's choice of alternatives? Deflation, or currency devaluation?

The movement for currency depreciation gathered momentum since 1930 "till by the beginning of 1933 the foreign trade of the countries with depreciated currencies represented about 52 per cent. of world trade. By the end of April 1933 when the U.S.A. dollar depreciated the share increased to 64 per cent. The remaining 36 per cent. represented the trade of the countries adhering to an effective gold standard (about 20 per cent of world trade) and of the countries maintaining an approximate gold parity of their currencies by means of exchange restrictions (about 16 per cent of world trade)".* India joined this general movement under the leadership of Great Britain. When Great Britain abandoned the gold standard the rupee, being linked to sterling, naturally depreciated in terms of gold. Hence those who are clamouring for the devaluation of the rupee have been told that since the rupee has already been subject to devaluation like the currencies of countries forming the sterling bloc, India has actually obtained whatever relaxation or relief may have been secured by other agricultural countries through currency depreciation. Unfortunately such an argument is complacently advanced, and sometimes equally complacently accepted, without

Review of World Trade, 1932. (League of Nations).

discrimination, and it is necessary to examine whether facts furnish a solid ground for such self-complacency.

Theoretically moderate depreciation of the foreign exchanges—as opposed to depreciation caused by hyper-inflation and accompanied by economic dislocation, as during the Great War—provided the exchange rate is approximately kept stable at a new lower parity, acts as a bounty on exports and as an *ad valorem* restrictive duty on imports. As internal costs and prices adjust themselves to the exchange depreciation the extent of the bounty on exports and the restrictive effects on imports are, no doubt, *pro tanto* reduced. But there is a permanent advantage in foreign trade to the extent that certain internal costs, such as long-term interest and rent charges (and to a smaller extent various tax charges) which form important elements of cost in Indian agriculture and are fixed in terms of money, fail to rise. Moreover even supposing that most of the direct advantage of depreciation is temporary, since currency depreciation in a period of depression has that kind of expansionary and recuperative effect upon internal economy which is cumulative in its momentum, it has ultimately an expansionary effect upon both exports and imports in the long period. Hence it is wrong to suppose that all the effects of exchange

depreciation necessarily exhaust themselves in the short period.

What have been the effects of currency depreciation on the foreign trade of the countries with depreciated currencies in general and of India in particular ? Professor James W. Angell of Columbia University has given us an admirable survey of the general effects of currency depreciation on foreign trade in his address delivered before the Academy of Political Science in 1933.* It is obvious that these effects can not be isolated from the contemporary economic phenomena and tendencies, such as the deepening of the economic depression, protectionism, development of economic autarchy and the erection of various kinds of trade barriers. As Prof. Angell points out, on account of the deepening of the economic depression "nearly all of the phenomena at issue must be measured in terms of a shrinking base."† Moreover, to the extent that tariffs and import restrictions were employed by the gold bloc to shut out imports from countries with depreciated currencies, the expansionary effect of

* *Proceedings of the Academy of Political Science Vol. XV. June, 1933*, Prof. J. W. Angell's address on Exchange Depreciation, Foreign Trade and National Welfare.

† Op. Cit p. 11.

devaluation on exports of the latter was neutralized. Nevertheless on the basis of available data we can reach some general conclusions with confidence. For purposes of comparison the 'stable' countries selected by Prof. Angell are Austria, Belgium, Czechoslovakia, France, Germany, Holland, Italy, Poland, Switzerland and the United States of America, while countries with depreciated currencies selected by him are Denmark, England, Norway, Sweden, British India, Argentine, Canada, Chile, China, Japan, Mexico, Peru and Spain. In the case of the latter exchange depreciation had been, on the whole, moderate; "the average foreign exchange rate in December 1932 stood at 69·4 p. c. on the gold par, with a range for the group between a low of 42 and a high of 91."* But it must be noted that in spite of exchange depreciation the level of wholesale prices and the cost of living indices in these countries were virtually the same in 1932 as in 1931. In the ten principal 'stable' countries the average wholesale price level for 1932 stood at 89 p. c. of 1931 and the average cost of living index at 93. But for eleven of the "depreciated countries" the average wholesale price level in 1932 stood at 103 p. c. of 1931 and the cost of living index at 98.†

* Op. cit. p. 12.

† Op. cit. p. 13.

The remarkable stability of wholesale prices and cost of living in the countries with depreciated currencies implied a *relative rise* when the indices were falling very sharply in the countries of the gold bloc. "Had the average price index for these depreciated countries risen in full proportion to average exchange depreciation, with prices in the stable countries taken as the base, it would have reached 128. The adjustment of internal prices to the new exchange levels which usually appears in due course was, hence, only about a third completed by the end of 1932."* Thus here we come across a typical problem of the short-period effects of moderate exchange depreciation on foreign trade. The relevant facts bearing on this problem are embodied in the comparative Table on page 106. The figures for export and import values of 'stable' and 'unstable' countries have been taken from the Table compiled by Prof. Angell, while for purposes of comparison and contrast from our point of view we have worked out the comparable data for India, Canada, Argentine, and England.†

It will be observed that the conclusions drawn from theory are definitely confirmed by facts. As regards imports the average total money value in 1932 was 56 per cent of the base figure in the case

* Op. cit. p. 13.

† Op. cit. p. 14. foot-note.

PERCENTAGES OF EXPORT AND IMPORT VALUES

	Stable (10)	Unstable (13)	India	Canada	Argentine	England
Imports:						
1932 Imports as percentage of 1929	42	50	52	35	43	58
1932 Imports as percentage of 1931	69	77	98	73	71	80
Average	56	64	75	54	57	69
Exports:						
1932 Exports as percentage of 1929	40	51	42	45	59	50
1932 Exports as percentage of 1931	60	85	82	87	89	93
Average	50	68	62	66	74	71
Average for total trade.	53	66	68	60	66	70
Index of Industrial Production:	Stable. (8)	Unstable. (5)				
1932 as compared to 1929, 1931 Average	–32	–11	X	X	X	–8

of countries with stable currencies, while it was only 64 per cent in the case of countries with depreciated currencies. On the other hand, the average total value of exports dropped to 50 p.c. of the base in the case of 'stable' countries and to 68 p.c. in the case of 'unstable' countries. Thus when we take a broad base, viz., the average of 1929 and 1931, we reach several interesting conclusions. First, the decline in the value of the total foreign trade as well as of imports and exports taken separately was much less in the case of 'unstable' than in the case of 'stable' countries. Secondly, the decline in exports was greater than the decline in imports in 'stable' countries, while the decline in exports was less than the decline in imports in 'unstable' countries. Thirdly, as regards the expansionary effects of exchange depreciation on industrial production, it seems that the decline in industrial production or deflationary contraction caused by the economic depression was very much greater in 'stable' than in 'unstable' countries. From the point of view of foreign trade also the decline (in both import and export trade) was arrested to a much greater extent in 'unstable' than in 'stable' countries. And it is particularly remarkable that in 1932 the average total value of exports was as high as 85 p.c. of that in 1931, in the case

of unstable countries, and only 60 p.c. of the average total export value of 1931 in the case of 'stable' countries. On the whole, therefore, it can not be seriously contested that, although there was no positive economic recovery in the unstable countries, yet exchange depreciation operated as a definite anti-cyclical force in these countries, counter-acted the general process of deflationary contraction, and helped them to maintain equilibrium in the balance of international transactions by means of a relative expansion, or, to be more accurate, a less rapid contraction of their export trade.

Now let us analyse the position of India as compared to two other agricultural countries which were similarly situated and also as compared to England whose currency management determined the direction of Indian currency developments under the sterling exchange standard. In the case of Canada and Argentine there was a drastic reduction of imports, so that in 1932 the average total value of imports was respectively 54 p.c. and 57 p.c. of the average of 1929 and 1931. But the comparable figures for the average total export values are 66 p.c. and 74 p.c. respectively. This means that the situation as regards foreign trade was conducive to external equilibrium. In the case of India, curiously enough, the situation was different. It is remarkable

that the average total import values in 1932 amounted to as much as 75 p.c. of the average total value for 1929 and 1931. This is the highest of the comparable figures in the whole Table. In other words the reduction of imports was the least when we compare her with 'unstable' countries in general and agricultural countries in particular. On the other hand, when we compare export values we are equally struck by the fact that in the case of India the decline in exports was more than in unstable countries generally, a little more than in Canada and considerably more than in Argentine. Moreover, it appears that after the abandonment of the gold standard by England the decline in imports into India was arrested to an unprecedented extent, the import values in 1932 being virtually the same as the import values in 1931. At the same time, the decline in exports between 1929 and 1932 was almost as much as the decline in the exports of the countries of the gold bloc. After the depreciation of the exchanges the fall in exports was arrested to a much greater extent in India than in the gold standard countries. But it is obvious that this fall was arrested to a smaller extent in India than in unstable countries generally and other agricultural countries particularly. On the whole, facts clearly show that India resembled 'stable' rather than 'unstable' countries in two important respects :—

(1) the decline in exports was much greater than the decline in imports; and (2) there was a very heavy decline in exports between 1929 and 1932, the extent of the fall in exports being almost the same in India as in 'stable' countries. Hence the situation as regards *foreign trade was hardly conducive to external* equilibrium which had been threatened with the onset of the depression and even earlier. Nor was this all; the situation was aggravated further by the maintenance of imports at a much higher level than in countries with depreciated currencies and in countries with stable currencies. In fact the average total import value in 1932 was as much as 75 p.c. of the average for 1929 and 1931.

When we compare and contrast the effects of currency depreciation on external equilibrium in the case of India with those in the case of England we reach certain conclusions which have an important bearing on the recent ratio controversy. As every student of modern currency history knows, the immediate cause of the failure of the gold standard in England was the withdrawal of foreign balances on a tremendous scale, while her foreign assets were frozen and unrealizable. But as Sir Walter Layton says, "that is only part of the story, for behind this capital flight was the fact that during the preceding year our *(England's) national trading account*

*had been getting more and more out of balance.''** England was buying more than she could sell, and one of the most important reasons why the balance of accounts was moving against her was that she was "almost the only remaining free trade country in the world surrounded by a ring of tariffs which were rising higher and higher." So long as the stream of international lending did not dry up, it was possible for her to meet the situation by foreign borrowing. But when international lending ceased "it became imperative to balance our (England's) current account, which meant that by some means or other our (England's) imports must fall or our (England's) exports increase. There was no other possibility." Thus fundamentally England had found herself in the category of agricultural countries like India which had been struggling hard to maintain equilibrium in the balance of international transactions earlier than the economic crisis of 1931. Now what means were adopted in England for

---

* An address on International Co-operation delivered by Sir Walter Layton, C.B.E., C. H., in June 1930 before the American Academy of Political Science, (Proceedings of the Academy p.p. 74-76). We have quoted extensively from this address specially because Sir Walter Layton is a recognized authority on currency and finance and his opinions are regarded as authoritative not only in Great Britain but also in India.

restoring external equilibrium? The most important instrument for restoring external equilibrium was the devaluation of sterling. "When the pound fell it settled down after a while at a level which has gone a long way toward restoring equilibrium in our balance of payment", and "the level to which the British exchange fell was largely determined by the level of the tariffs and the severity of other restrictions which were existing against British trade".* Here we have a conspicuous example of rational currency management based on the manipulation of the exchange rate with a definite objective. Thus the level of the pound, which was maintained by means of the Equalisation Fund, was, in the words of Sir Walter Layton, "a level determined by the existing situation of international trade barriers and all the concomitant series of conditions which determine trade. It was, therefore, not a level which we chose but, in a sense, a *natural level*".† The

* The process of external equilibrium was also helped by protectionism and subsequently by the operation of the Ottawa Agreement.

† We wish the currency experts of the Government of India had this notion of the natural level of the rupee. It may be mentioned here that the principal object of maintaining equalisation accounts has been to offset influences operating through the balance of international payments on the internal economic structure.

success of the British currency policy was not long delayed. If we examine the statistics in the Table given above we observe (1) that the level of exports in 1932 was maintained at 71 p.c. of the average for 1929 and 1931 and at 93 p.c. of the exports of 1931; and (2) that there was only 8 p.c decrease in the index of industrial production as compared with an average of 32% in the case of the gold standard countries, and 11% in the case of the countries with depreciated currencies taken as a whole. Gradually the internal strength and stability of sterling, which was reinforced by a number of countries, particularly India, linking their currencies to sterling, asserted itself, and gold began to flow back from many countries of the gold bloc to the sterling area.

It must not be supposed that these results were brought about by a dose of active internal inflation caused by expansion of currency and credit. After the abandonment of the gold standard the wholesale prices as well as the quantity of currency and bank deposits in England were remarkably stable. But since internal prices in gold standard countries were declining rapidly and soon fell by 10 to 20 p.c. there was a *relative rise* of internal prices in England which had an expansionary effect on business activity. Hence, as Sir Walter Layton pointed out, "though we may be solvent internationally in the

sense of paying our way and balancing our accounts both our incomes and outgoings are extremely low; *and we are faced with the problem, as everybody else is faced, of raising the price level".* But a rise of internal prices in England through reflation was keenly anticipated in all the countries of the sterling area. In fact, the expansionary effect of reflation in England would have transmitted itself more easily to the sterling bloc and would have gone farther than under gold standard conditions. But in England, as Hawtrey, whom we have already quoted, says, "the opportunity had been lost, deflation and falling prices prevailed in spite of the abandonment of gold, and the pound sterling had become a currency only one degree less intolerable than gold itself". The policy of easy money adopted later came too late, because the vicious circle of deflation had already been rejoined. Whether a reflationary policy would have suited British economic interests and needs was an open question or 'problem,' as Sir Walter Layton puts it. Perhaps internal inflation in England immediately after the abandonment of gold would have made it impossible to maintain the strength and stability of sterling in relation to gold. But agricultural countries like India which have to bear a heavy burden of external obligations were not on the same footing as England and did not 'obviously

desire that the deflationary effect of the British currency policy should transmit itself to their internal economic structure through the sterling link. Sweden, for example, took the necessary step and re-adjusted her exchanges in relation to sterling to suit her own special needs. Thus, it is interesting to note that exchange control in Sweden "was not only secondary to, but was actually employed as a means toward internal stablization. The pound at first depreciated more rapidly than the Krona, and in October, 1931, was quoted 7% below Krona parity. This was consistent with Sweden's determination to prevent inflation. In December, 1931 the old Krona-pound parity was almost restored, and beginning April, 1932, in accordance with Sweden's desire to reflate wholesale prices, the pound was quoted about 7½ % above par, except for the period from November 1932 to March 1933, when the old parity with the pound was temporarily re-established." *

India was unfortunately not free to strike out a path of her own. The rupee had to trim its sails to the winds of sterling. Hence with the rupee-sterling ratio pegged at the same level, the sterling link transmitted very easily the deflationary effect of the British currency policy. But what is more tragic is

---

*Fisher, *Stablized Money*, p. 400.

that the internal economic structure of India had to go through a grinding process of price deflation which was without any parallel in the sterling area. As already emphasized, from 1931 onward the price level in the countries with depreciated currencies remained stable; the decline was stopped, and was followed by a rising tendency after a year or two. In India immediately after the devaluation of the rupee in terms of gold the index number of prices moved up from 91i n September, to 98 in December, 1931 when the depreciation in terms of gold was the highest in the case of the rupee and the pound. But after December, 1931 the rise of prices was counteracted, and after the close of the year 1932 prices began to fall below the level of September 1931, The index number reached the lowest level of 82 in March 1933. Between March 1933 and 1937 there was no further decline; nor was there any appreciable upward movement. On the other hand, as early as 1935 there was a definitely upward movement of prices in *all except the gold standard countries*, and the divergence between the national price levels was closing up in the case of most countries. On the whole, we find that India's external equilibrium was threatened in the same way as the external equilibrium of countries adhering to the gold standard. And it is sad to reflect that in India exchange

control was not employed, as in Sweden, "as a means toward internal stabilization". Nor was it employed, as in Great Britain, as an instrument of "restoring equilibrium" in the balance of trade which was being threatened as the result of the disparity between import and export prices since 1926.

Since currency management failed at a crucial moment to restore external equilibrium through a re-adjustment of the trade balance, India had to resort to gold exports in order to maintain equilibrium in the balance of international transactions. Exportation of gold from India in recent years has been commonly regarded as a unique economic phenomenon. The phenomenon is certainly unique when we come to think of the volume and continuity of the outflow of gold and observe how the rôle of India as a habitual importer of gold has been suddenly reversed.* But fundamentally the phenomenon was not unique

*According to a statement recently made by the Finance Member in the Assembly since Great Britain went off the gold standard gold to the value Rs. 326 Crores has been exported from India. According to a tentative estimate given in the annual report of the Bank of International Settlements for the year 1934-35 gold hoarded in India from 1893 to 1930 amounted to a minimum of Rs. 1,454 Crores. Of this amount 22·4 per cent has been exported since 1931.

in so far as her position was essentially the same as that of many debtor countries with gold standard currencies who had eventually to go off gold and resort to currency depreciation as the only means of avoiding national bankruptcy after the financial crisis of 1931. Ever since the first half of 1929 when France withdrew her foreign short-term assets and a period of contraction of foreign lending began, many debtor countries with gold standard currencies were forced to counter-balance the change in the credit situation by repeated gold exports. When by the middle of 1931 international capital movements were completely arrested as the result of the financial crisis, the gold reserves of numerous debtor countries were largely depleted, and the only alternative left for them was devaluation of their currencies. From the end of 1932 to September, 1936 we observe a reversal of gold movements, i.e., a flow of gold from the gold bloc to the sterling area*. The fundamental causes which induced the reversal of the gold movements were the same. Exchange depreciation in the sterling area exerted a deflationary pressure on internal prices in the gold-standard countries and restricted their

* Gold was lost by Netherlands, Switzerland, Italy and most of all by France, and was acquired by U.S.A., United Kingdom. Sweden, Norway, S. Africa, Portugal, Egypt, Finland and Belgium.

exports while stimulating imports from countries with depreciated currencies. Hence those countries which did not resort to drastic exchange control and import restrictions were faced with disequilibrium in the balance of international payments and began to export gold in fairly large quantities.*

The mechanism of gold exports has brought into sharp relief some of the fundamental features of Indian currency management during the Great Depression. It may be recalled that gold exports were induced first by the very act of the devaluation of the rupee in terms of gold which at once raised the rupee-price of gold. Since gold is a commodity which is universally acceptable, the demand for which has increased greatly due to rise of liquidity preference caused by the depression (there being an upward shift in the demand curve for gold) and which has not to encounter trade barriers in the course of its passage from one country to another, the exports of gold were at once stimulated

* It should be noted that countries with depreciated currencies also resorted to purchase of gold as a method of maintaining their foreign exchanges at a low level in terms of gold. For example, the Swedish Riksbank increased its gold holdings by 164 million Kroner between March 1933 and December 1933 with this object in view.

particularly at a time when the value of agricultural products (which we export) in terms of industrial products (which we import) had fallen to the detriment of our active balance of trade. Had there been a reflationary rise of domestic prices immediately either (1) by prohibiting the exports of gold and commandeering private hoards and converting them into a basis of expansion of paper money, as was done in America, or (2) by expansion of currency even when retaining the sterling link, the outflow of gold would have slowed down and would have been eventually arrested altogether. But as already pointed out, there was heavy price deflation in India which heightened the deflationary effect of the economic depression and broadened the difference between the external price and the rupee price of gold. To elucidate this statement we would emphasize an important peculiarity of the dishoarding of gold in India. It is very often ignored that gold for export has come not from the currency reserves of the central bank as in other countries but from private hoards. In India these private hoards of gold have represented a form of capital asset like land from time immemorial. Under deflationary pressure the agricultural population have been compelled to part with these assets. Thus the dishoarding of gold is merely the effect of debt liquidation which is a universal phenomenon connected

with the process of economic contraction. When the contraction process has already set in a debtor when he is pressed to repay a loan "is not always in a position to meet his obligation out of his current receipts. Ordinarily he will be forced to sell assets in order to raise the fund for the discharge of his debt. He may sell securities, real estate, or commodities of different descriptions. These forced sales must have a depressing influence on the price of the assets with deflationary consequences"* There is no doubt that in India the bulk of the internal sales of gold has been of the nature of forced sales which have had a depressing influence on the rupee-price of gold thus widening the difference between the internal and the external prices of gold and stimulating gold exports in unusual quantities.

The maintenance of the rupee-sterling link at 1s. 6d. to the rupee concurrently with heavy internal price deflation has constituted a conditioning factor of gold exports. As the result of the internal appreciation of the rupee, its external purchasing power remaining the same, the rupee was undervalued in relation to sterling. According to the League of Nations' report on commercial banks (1929-34), the extent of the undervaluation of the rupee was 10·31

* Haberler, *Prosperity and Depression*, p. 235.

p.c. in 1931, 15·04 p.c. in 1932, 16·18 p.c. in 1933, and 18·23 p.c. in 1934. Since, as already pointed out, prices in India remained consistently low between 1934 and 1937, whereas there was an upward movement in other countries after 1935, the undervaluation of the rupee increased still further. Thus the state of the exchanges was such that the rupee price of gold was lower than its sterling price expressed in rupees at the prevailing rupee-sterling market rate. But it must be borne in mind that undervaluation of the rupee was merely a conditioning factor in the process of gold exports, a reflection of the internal overvaluation of the rupee due to heavy price deflation. It is interesting to speculate how internal price deflation could be maintained in the face of the external undervaluation of the rupee and thus turned out to be the predominant factor in the Indian economic situation. First, owing to the upward shift in the demand curve for gold as compared to the demand curve for particularly agricultural products during the depression, the undervaluation of the rupee had an expansionary effect on gold exports rather than on commodity exports. Secondly, the forced sales of capital assets like gold and also land have intensified the economic depression in the countryside. In so far as the sale proceeds of gold converted into negotiable securities have formed the

basis of new bank deposits, or cash has been dishoarded to buy gold, an expansionary effect of gold sales is conceivable. But it is doubtful whether gold exports have increased financial circulation and contributed to internal expansion to any appreciable extent. Lastly, it is not inconceivable that the currency authorities pursued an active deflationary policy which was indispensable for a smooth working of the mechanism of the dishoarding and export of gold.

It is not contended here that gold exports *per se* have led to economic disaster. We are inclined to agree with Keynes when he says that "in time of peace to substitute goods for gold when goods are cheap in terms of gold and gold for goods when goods are dear in terms of gold will be both socially and financially profitable".* But what we condemn is the fundamental cause of gold exports, viz., the heavy price deflation which has made the rupee a currency which has been perhaps as intolerable as gold and not "a currency only one degree less intolerable than gold itself", as Hawtrey characterized the pound sterling after September, 1931.

The above survey of the nature and methods of

---

* C.f. A paper recently read before the Economics Section of the British Association.

currency stabilization in India in the post-war period reveals a rationale of currency management which demands the closest scrutiny at the present juncture. In India the principle of stabilization that has been traditionally followed is the principle of exchange stability. It is obvious that if the exchange-rate is maintained at a particular level which is regarded as the basic norm, the internal economic structure is exposed to economic fluctuations originating in other countries—fluctuations which may be not only of the nature of secular dynamic changes in economic life but also short-run fluctuations within the secular trend which it has been the ordinary task of monetary authorities in the post-war world to moderate by deliberate devices. In the pre-war world of international gold standard and comparative freedom of trade the operation of the gold standard guaranteed within limits stability of prices as well as stability of exchanges. There used to be a fixed purchasing power parity based on gold parity which maintained the national price levels fairly in harmony with one another. Both international equilibrium or harmony of national price levels and the adjustment of the internal structure of prices, production, wages and other money incomes to the fixed purchasing power parity were achieved to an appreciable extent through a fairly flexible economic system, a fairly equitable

distribution of gold and a fairly smooth working of the international gold standard. Under these conditions exchange stability more often than not secured price stability. But in the present day world conditions are just the reverse. Thus we observe the phenomena of closed economic systems based on more or less self-sufficient and rigid economic structures; of systems insulated against external economic pressure and disturbances by exchange depreciation, exchange control and tariff and other trade barriers; of acute disharmony of national price levels; and of fluctuating purchasing power parities. These fundamental changes are due, among other things, to the breakdown of the international gold standard. Under these changed conditions the maintenance of exchange stability has exposed India's internal economic structure to grave international maladjustments which have shaken the foundations of world economy in recent years, and has profoundly disturbed her external equilibrium. In this respect her currency policy has run counter to both enlightened economic theory and actual practice.

Judged from this point of view post-war currency stabilization in India has betrayed its inherently artificial character. The attempt to stabilize the rupee at 2 s. gold in 1920 was a dismal failure, because the catastrophic fall of external prices, which

was transmitted through an overvalued rupee, was too much of a disturbance to be tolerated by our internal economic structure and price system. The subsequent decision to leave the exchange-rate to find its own level had a salutary effect upon our internal economy. As Keynes testified before the Hilton-Young Commission, the currency authorities by abstaining from exchange pegging at a time when world prices were in serious disequilibrium protected the internal economic structure to a certain extent against the fluctuations in gold prices during the boom of 1919-20 and the slump of 1921-22. During the ratio controversy of 1926 foreign as well as Indian experts urged with commendable foresight that since national price levels were still out of harmony and were still fluctuating the currency authorities should sit on the fence and await developments. But if they stabilized the rupee without "maintaining legislative freedom to adjust her exchange to the events in the outside world and so preserving the stability of her internal prices" they might be guilty of importing serious instability into the costs-prices structure if world prices fluctuated later. Sir Basil Blackett must have toyed with the ideal of price stability ; otherwise it is amazing that he should have sought to prove that exchange-stability at the *de*

facto rate of 1s. 6d. implied also internal price stability on the ground that British, American and Indian prices had somehow "come together at a figure about 160", and that he should not have taken the elementary precaution suggested by Keynes and other Indian and foreign witnesses. The fact is that the movement for stabilization in India was inspired, if not dictated, by the restoration of the gold standard in Great Britain in 1925. But, as events have amply demonstrated, stabilization was ill-advised and inopportune in both countries. As Sir Walter Layton says, "The mistake that we made in 1924 was to endeavour to set up an international monetary system without first making sure that the economic background was right". We do not know how the "economic background" was studied in England; but it is amazing that in India so much was made of the accidental parity of British, American and Indian prices and that such exaggerated emphasis was laid on measurements of purchasing power parity based on comparisons of price levels as if these afford reliable criteria of overvaluation or undervaluation of a country's currency. At any rate, as Keynes has shown, the pound sterling became overvalued in relation to gold after 1925 and exercised a deflationary effect upon England's foreign trade and

dislocated her internal economic structure.* In India the link of the rupee with the overvalued sterling transmitted the fall of sterling prices between 1924 and 1929 to the Indian price system, and created internal instability of prices not only absolutely but also relatively to prices in countries which were the best customers of India. So far as external equilibrium was concerned it was also threatened by a fundamental change in the barter terms of trade which manifested itself in 1926-27 and was subsequently reflected in the steadily shrinking active merchandise balance of trade in later years thus threatening the equilibrium of India's balance of international payments.

During the years of depression the two-fold disturbance to which Indian economic life was exposed after the currency stabilization of 1927, viz (1) internal price instability manifesting itself in heavy price deflation and (2) the shrinking of the active merchandise

---

* C. f. Keynes, "*Economic consequences of Mr. Churchill*". In an addendum to the *Report by a Court of Enquiry concerning the Coal Mining Industry Dispute, 1925*, Sir Josiah Stamp dissented from his colleagues in coming to the conclusion that the main causes of the troubles in the British coal mining industry were deflation and England's return to gold.

balance of trade, was accentuated first by the agricultural depression and then by the industrial slump. Such maladjustment was not peculiar to either Great Britain or India. But a dispassionate survey of facts given above demonstrates very clearly that while Great Britain and agricultural countries like Australia and Sweden had succeeded, after the abandonment of the gold standard, in stabilizing internal prices by reflationary adjustment, or at least by arresting the avalanche-like fall of prices, and in restoring external equilibrium through an absolute, or at least relative, rise of prices combined with the devaluation of their currencies, India has pinned her faith on the traditional policy of exchange stability which has transmitted the devastating deflationary shocks of the world economic depression to her internal economy.

Curiously enough, we find a divergence between profession and practice in the realm of monetary policy both in the case of Great Britain and India. At the Imperial Economic Conference held at Ottawa in 1932 authoritative pronouncements were made by representatives of the Empire countries on the question of monetary policy. The Conference was held to lay the foundations of an inter-Imperial stabilization of commercial and monetary relations. Sir Henry Strakosch, Member of the Council of India, while enunciating the Imperial monetary policy, declared

on this occasion: "Pending the re-establishment of a stable international monetary standard the Empire countries should as far as possible adopt a common standard of value, and the wholesale level of prices in terms of that common standard should be raised to a point at which an equilibrium is re-established between costs and that level of prices. Further, on the attainment of that level, monetary policy should be directed towards maintaining it stable both in terms of commodities and in terms of other Empire currencies. The United Kingdom being the greatest centre for Empire trade and finance, and being in a very strong creditor position *vis-a-vis* the rest of the Empire, the trend of prices in terms of the common standard must depend in the main upon the monetary policy she decides to pursue."* We cannot imagine a clearer enunciation of the policy of a reflationary rise of prices with the object of re-establishing the costs-prices equilibrium. It is obvious that Sir Henry regarded the costs-prices equilibrium as the fundamental basis of stabilization and exchange-stability as an objective which must be subordinate to, and consistent with costs-prices equilibrium. Had this rational monetary policy, so ably stated by one of the accredited representatives of

---

* Imperial Economic Conference 1932. Report to the conference, p. 142.

India, been only partially followed by the Government of India, India's economic travail during the depression would have been mitigated to a considerable extent. Sir Henry Strakosch gave a broad hint that Great Britain should take the lead in reflationary readjustment. The leader of the New Zealand delegation put the issue more clearly when he said : "We can make some local adjustments, but it is simply impossible to restore even a reasonable measure of sound conditions in the Dominion unless and until the general price level in Great Britain is increased, and *increased substantially.* That is something which can not be left to take care of itself."* The response of Mr. Neville Chamberlain, Chancellor of the Exchequer, was no less clear and emphatic. He said : " I want to make it perfectly clear at once that upon the desirability of raising wholesale commodity prices the United Kingdom Delegation is in full sympathy and agreement with the Dominions and India."† At the London Economic Conference held in 1933, which broke up as the result of a clash of monetary policies, the United States of America and Sweden wanted to reflate their domestic price levels before stabilizing exchange; while France, England and some other

---

* Op. cit p. 126.

† Op. cit p. 143.

countries favoured a temporary exchange stabilization prior to domestic reflation. We need not go into the merits of the two policies. But there is no doubt that both parties did want a reflationary adjustment of prices with a view to restoring the costs-prices equilibrium. In spite of the failure of the Conference it is significant that Great Britain and the majority of the countries belonging to the "Sterlingaria" reiterated the policy enunciated at Ottawa, and signed a so-called Imperial Declaration which said that *a continued rise in commodity prices was most desirable in order "to restore the activity of industry and employment, insure an economic return to the producer of primary commodities, and harmonize the burden of debts and fixed charges with economic capacity".** Indians hardly realize that what they have been demanding for such a long time and even now (of course very often with a wrong and perverted emphasis) is incorporated in an Imperial Declaration which the Government of India was, and still is, morally bound to respect and implement.†

*Fisher, *Stabilised Money*, p. 359.

†Mr. Reginald Mckenna in the *Midland Bank Monthly Review, January—February, 1934*, expressed the opinion that "This declaration may well prove the most important profession of faith the world has yet had on the subject of monetary policy".

Subsequent events have shown that Great Britain has paid only lip homage to the ideal of reflationary stabilization of sterling prices. Mr. Reginald Mc-kenna who was so enthusiastic about the Imperial Declaration believed that the signing of this Declaration by England placed upon the Bank of England the responsibility of initiating a new monetary policy. But price reflation has not gone so far as it should have gone in the interests of Imperial economic stability without which Imperial monetary unity has little meaning. Nevertheless, Great Britain has solved her domestic problems more or less successfully. The devaluation of the pound after September, 1931, in so far as it corrected its previous overvaluation in terms of gold had an obvious expansionary effect upon industry, trade and employment. As Sir Walter Layton says, by means of devaluation the continuing pressure of an adverse balance of trade was removed and external equilibrium regained. But the central feature of British currency management during the depression is imperfectly realised in this country. In the words of Sir Walter Layton which bear repetition, the pound has been allowed to find a "natural level"—a level determined by "the existing situation of international trade and all the concomitant series of conditions which determine trade". Moreover, influences operating on the internal eco-

nomic structure through the balance of international payments are offset by the operation of the Exchange Equalisation Fund. Thus there is no rigid exchange stability which is regarded as sacrosanct and as an unalterable basic norm. Although no country understands the need for maintaining reasonable exchange stability better than Great Britain, yet there is at the same time a keen anxiety not to over-emphasize the claims of exchange stability to the detriment of the internal costs-prices structure.

Other countries of the "Sterlingaria" for want of a definite lead from Great Britain in the shape of a "substantial rise" of sterling prices appear to have fallen back upon a domestic solution of their particular monetary problems. For example, as already pointed out, Sweden pursued an independent policy of reflationary stabilization of internal prices and stabilization of the cost of living even at the expense of exchange stability in relation to sterling, thus insulating her internal economic structure almost completely and effectively against the world depression.* The basis of this policy was to make "wise adjust-

*This shows, as Dr. Fisher maintains, "that the foreign exchange value of the Krona was determined independently of the pound, that is, Sweden did not properly belong to the 'Sterlingaria' group". (*Stabilised Money*, p. 400)

ments of foreign exchange operations to the domestic requirements of the country; that is, purchasing foreign exchange to maintain a low foreign valuation of the Krona; abandoning the exchange stability of the Krona with the English pound when such exchange stability tended to pull down the Swedish price level; but maintaining a stable sterling exchange when the beneficial influence of a rise of British wholesale prices could thus be made to effect a corresponding rise in the Swedish wholesale price level."* In Australia the gold standard was abandoned in November 1929 in order to permit her "the full use of her gold reserves to meet external obligations"—a course of action similar to what India adopted after September 1931.† But eventually Australia resorted to considerable devaluation as a reflationary measure, and the depreciation "proceeded to a point where 185 Australian paper pounds were equivalent to 100 gold pounds, that is, the price of gold was raised 85 %."‡ On the other hand, India has persistently clung to exchange stability at the cost of internal price stability—a policy which has, as we have shown, led to unprecedented price deflation and

*Fisher, *Stabilised Money* p. 330.

†Ibid p. 334.

‡Ibid p. 338.

paralysis of economic activity and is warranted neither by the professions of her accredited representatives nor by the theory and the practice of postwar currency stabilization.

CHAPTER IV

DEVALUATION OF THE RUPEE — THE PROBLEM AND ITS SETTING*

The case for the devaluation of the rupee presented above in the context of long-run tendencies and the fundamental maladjustments of our national economy, and from the point of view of the post-war monetary theory and practice, has been stated in such a manner as to clear up the radical issues involved in this controversy. This is not really a narrow issue between a historic norm of 1 s. 4 d and the norm of 1 s. 6 d. which has become equally historic. The issues are much wider. Do we want price stability or exchange stability in the abnormal circumstances of the post-war world? Devaluation being a means to an end, i.e., an instrument of monetary stabilization, is it enough to secure a reflationary stabilization of the internal price level and get rid of the heavy price deflation which has paralysed the economic life of the country? Or should it be supplemented by other measures? Do we want a

* For a succinct discussion see my chapter on the Problem of Devaluation in "Economic Problems of Modern India".

national solution of the problem of price deflation by insulating our internal economy against external disequilibrium? Do we want alterable exchange parities and the freedom to adjust the ratio according to the fundamental needs of our national economy? Do we want to allow the exchange-value of the rupee to fall in the same way as Great Britain has recently allowed the sterling-dollar rate to fall from the historic par of 4·86 to about 4·66 in the course of a few months in order to correct the over-valuation of sterling and thus to improve her export trade? These are the fundamental questions involved in this controversy. And we have already indicated the manner in which these questions ought to, and have actually been, answered particularly by agricultural countries similarly situated as India.

Unfortunately the question of devaluation has been recently debated against a narrow background of the recent trade recession and the difficulties of the currency authorities in the face of sagging exchange. Such a procedure is apt to cloud the wider and more vital issues. If, for example, it is proved that the present ratio should not be altered on fundamental grounds, and that it has a tendency to secure external and internal equilibrium in a fundamental sense, then there is no reason why it should be lowered simply

because the currency authorities have been facing temporary difficulties. If, on the other hand, the contrary is proved, and the ratio is not held to be justified by the known criteria of internal and external monetary equilibrium—if, for example, the rupee has been like sterling which was overvalued in relation to dollar until recently and had threatened the balance of payments of Great Britain and was, therefore, allowed to depreciate to reach a natural level, then, of course, there is a rational case for devaluation.

There is no doubt that the Working Committee of the Congress did not state the real issues clearly in the resolution which was the subject of a recent Government Communiquè. They say, "Since June last the balance of trade has turned more and more against India. The Committee are of opinion that the rate of 1 s. 6 d to the rupee has hit hard the agriculturist of this country by lowering the price of agricultural commodities and given an undue and unfair advantage to imports into this country. The Working Committee are satisfied that the rate of 1 s. 6 d. cannot any longer be maintained on the balance of trade." Unfortunately the Working Committee have started with a presumption which is not supported by the facts analysed above. The Government of India seem to have made much of this error, but, as we have already said, it is nothing but short-sighted com-

placency to regard the improvement in the active balance of trade since June 1938 as signifying a real upturn of the trade cycle. In fact, as the *Monthly Review of Business Conditions in India* for October shows, the foreign trade position deteriorated during this month and the larger exports of gold maintained the balance of payments as a whole. The second of the three statements quoted above, coming as it does after the first, (which, as a statement of fact, is erroneous) obviously appears to be connected with the first, and since it refers to a mistaken view of the situation as it developed after June 1938, it loses its force as an argument. The reply of the Government of India that "since June last the trend of the price-index of the chief articles of export has been definitely upwards" seems to clinch the argument, although as we have demonstrated there is no reason to be unduly optimistic about the trend of the prices of primary commodities such as India exports. But from a broader point of view it is a truism that India has suffered after 1931 from a heavy price deflation which has been without precedent in the rest of the sterling bloc, Indian agriculturists have been hit hard both absolutely and relatively, and since owing to gold exports the balance of trade could not be readjusted to a lower level of imports, foreign imports

have been restricted to a much smaller extent than they would have been otherwise. The Working Committee further say that during the last seven years the rupee ratio "has been maintained by large exports of gold which have been very injurious to the country." It is true, as we have explained, that gold exports have fortuitously helped the currency authorities to maintain foreign exchange on an even keel; but we do not maintain that gold exports *per se* have led to economic disaster. What we condemn is the fundamental cause of such gold exports, viz., the grinding price deflation which has made the rupee as intolerable as gold currencies. The Working Committee have also expressed their apprehension that "sterling resources have already been used up to an alarming extent, and there is a danger of further serious depletion taking place if efforts continue to be made by the Government of India to maintain the present ratio". We have discussed thoroughly how far inroads have been made upon the *sterling securities of the Issue Department of the* Reserve Bank. It seems that the ratio of 'A' to liabilities in the Issue Department is still about 9½ p.c. above the statutory minimum of 40 p.c. Hence, as we have shown, the extent to which sterling securities of the Issue Department may be drawn upon without deflationary effect on the note-issue is not inconsider-

able. In extreme emergency a part of the gold held as an asset of the Issue Department may also be utilised with safety, because the total value of the gold held in the Issue Department was Rs. 44 crores and about 41½ lakhs on the 16th December, whereas the statutory minimum is Rs. 40 crores. It appears, therefore, that although there is no need for "alarm" at the moment, obviously there is—since the depletion of sterling securities has been still continuing—no ground for self-complacency either. The Working Committee further argue that "matters have now reached a stage when the ratio can only be maintained by a policy of contraction of currency and credit". Our analysis has shown that during the period April—July, 1938 there was a phenomenal contraction of notes in circulation and that it is not unreasonable to think that there was considerable active deflation, although the contraction of the note-issue was obviated to some extent by the lowering of the ratio of 'A' to liabilities of the Issue Department. So far as credit is concerned the Reserve Bank followed during this period a commendable policy of easy money in relation to the short-term capital market. During the second half of 1938 there was a gradual expansion of notes in circulation, but the abnormal rise in the yield on Treasury Bills and heavy sales of these Bills created "unseasonal stringency" in September and

later on the monetary stringency, which had already developed, must have strengthened the basis of the rupee-sterling exchange.

It is interesting to estimate the probable effects of devaluation according to the communiquè of the Government of India. "The Government of India are convinced that a lowering of the ratio in the existing international market conditions would produce no appreciable rise in what the cultivator can realise for his produce. They are equally convinced that it would produce an immediate rise in the cost of what he buys". It is said that there will be no *appreciable* rise in export prices as the result of devaluation. Having maintained that our export prices are on the up-grade they cannot but admit that there would be a bounty on exports to the extent of the depreciation immediately. The bounty may not be appreciable but is certainly welcome in view of the collapse of export prices since the spring of 1937. But even if the up-turn in the cycle of prices and business activity fails to materialise in the immediate future, as we have reasons to think it will, devaluation would still be an effective instrument for fighting the economic relapse. In this connection we are strongly reminded of what happened in the case of Australia when she allowed her pound to depreciate 50 p.c. on gold and 20 p.c. on sterling in order to fight the

depression. As Professor Copland observes, "With the depreciation of the currency the fall in export prices in Australian currency stopped, though there were minor fluctuations."* In January 1931 the index number of export prices was 51 p.c. of the 1928 level in Australian currency. It fluctuated around 55 p.c. of the 1928 level in the year 1933-34 as the result of a strong rise in wool prices. On the other hand, prices in terms of gold reached a desperate position of 30 p.c. of the 1928 level by the beginning of 1933. This was certainly no mean achievement, and the statistics show that the volume of Australian exports was not only maintained but even increased through favourable seasons. India should certainly consider herself fortunate if she could at least prevent export prices quoted in rupees from falling by devaluating her currency. In the second place, the Government of India in their natural solicitude for the peasantry, who form the backbone of our economic life, fear that devaluation would be ill-advised since it would *immediately* increase the cost of imported goods that the peasant buys. Theoretically devaluation operates as an *ad valorem* restrictive

* *Lessons of Monetary Experience.* Prof. Copland's paper on Australian Monetary Policy in Depression, p. 410.

duty on imports at the same time as it acts as a bounty on exports. But it is a fallacy to think only in terms of the short-period effects of devaluation and to suppose that all the effects are exhausted in the short period. As we have said above, "there is a permanent advantage in foreign trade to the extent that certain internal costs, such as long-term interest and rent charges (and to a smaller extent various tax charges) which form important elements of cost in Indian agriculture and are fixed in terms of money, fail to rise. Moreover, even supposing that most of the direct advantage of depreciation is temporary, since currency depreciation in a period of depression has that kind of expansionary and recuperative effect upon internal economy which is cumulative in its momentum, it has ultimately an expansionary effect upon both exports and imports in the long period." Let us suppose for the sake of argument that the prices of imported and other goods rise eventually as the result of devaluation which is accompanied by internal price reflation. Now since the cultivator will enjoy a tempcrary bounty on exports and also a certain permanent advantage in foreign trade, his spending power will increase and he will afford to pay higher prices for the industrial products that he buys. For example, in Australia after devaluation had been

achieved imports increased from £ 44 millions to £ 56·6 millions during 1932-33 and rose to £ 82 millions by 1935-36. In the words of Professor Copland, *"Imports were recovering with the increased spending power accompanying recovery"** And at the same time the remarkable recovery of the export trade "obviated the necessity for incurring new borrowings in London".† Moreover it is necessary to bear in mind that when devaluation is accompanied by suitable, well-planned measures to initiate and speed up economic recovery (which are briefly discussed below) the prices of goods consumed by the masses need not necessarily be high in the long run. In Australia, for example, "the careful attention given to export production so that it might expand and the fostering of efficient secondary production competing with imports, were integral parts of the policy of recovery."‡ Similarly, speaking of Japan Mr. Eigo Fukai says, "We have also been favoured by a high productive capacity. If production could not keep pace with the increase in consumers' demand stimulated by the injection of increased supplies of money, a rise in prices would

*Op. cit p. 419.

†Fisher, *Stabilized Money p. 340.*

‡ Copland, Op. cit *Australian Monetary Policy in Depression*, p. 421

certainly result. So as long as there is a high potential productive capacity the supply of goods may be increased and high prices will not necessarily follow, but only augmented production and expansion in business transactions".* It is not necessary to assume that the "potential productive capacity" of India will not rise to the occasion if devaluation is accompanied by a rational plan of recovery and industrial expansion.

Another argument which has been used by Government against devaluation is that "it would seriously weaken the budgetary position of the Central Government and the larger Provincial Governments." Payments made overseas by the Central and Provincial Governments include interest on sterling debt, leave salaries and pensions, apart from the cost of stores. The total involved is about £35,000,000, and in the event of devaluation these transactions alone would add another Rs. 5 crores to Indian Central and Provincial expenditure. As to India's general annual purchases from overseas if the rupee ratio was lowered to 1s. 4d, Rs. 120 crores would have to be spent on what we are purchasing today for Rs. 105 crores. It is unfortunate that the Government of India fail to recognise the expansionary effects of devaluation on exports as

* *Lessons of Monetary Experience.* p. 394.

well as imports and on the entire internal economy. After all the Government budget reflects the state of economic activity and is dependent upon the incomes and profits of the people. If there is an all-round increase of both money incomes and real incomes, if there is increased turn-over of goods and business activity, and if both internal and foreign trade are stimulated as the result of devaluation and allied measures of economic recovery, there is every reason to believe that the loss sustained by way of exchange premium on our foreign debt services would be more than made good by the increasing yield of *the different sources of taxation.* In the case of Japan the statistical evidence indicates that as the result of the depreciation of yen there was "an increase of some 30 p.c. in the people's savings accumulated in the various financial institutions, a 50 p.c. increase in the output of staple manufactures, the doubling of the value of exports, and a gain of some 40 p.c. each in the national railway freight traffic, bank clearings and factory employment".* It can not be seriously suggested that such amazing recovery of economic activity and rise of incomes, profits, savings, investment and employment did not react favourably upon the Government budget.

* *Lessons of Monetary Experience* p. 394.

Similarly in the case of New Zealand,* "the effect of the depreciated exchange has been to raise export receipts in terms of New Zealand currency. For the latest year export values are about £ NZ 50 millions. At par of exchange with sterling they would have been £NZ 40 millions. The direct result is, therefore, to increase receipt from overseas, to expand the national income and the spending power of the people, to promote more active business, to maintain all security values and to augment taxable capacity. The only important money cost to the budget is the exchange premium on the debt service overseas which amounts to about £ NZ 1·75 millions on annual payment approximating £ 7 millions sterling. On the other hand the increase of £ NZ 10 millions in export receipts circulates throughout the country, stimulates all other industries, and tends to be more than doubled in its effect upon the national income. The gain in revenue from taxation, which ranges from 20 to 25 p.c. of the national income, tends, therefore, to be much greater than the cost of the exchange premium to the budget." In the same manner in Australia the rise in the index of ordinary shares from a low of 52·1 in January

* Mr. A. H. Tocker in *Economic Record*, March, 1935, p. 90, quoted by Dr. B. Adarkar in *Indian Finance*, August 6, 1938.

1931 to 86·5 in July 1933 and of preferred shares from 80·8 to 106·9 in the same period and the rise in the price of Government securities in spite of the drastic reduction of yield, indicated rising business activity which meant increased taxable capacity all round.

In the concluding portion of this essay we shall make an attempt to indicate the general lines on which there should be a re-orientation of the monetary and the fiscal policies of the Government if devaluation is to produce enduring results by initiating and speeding up the process of economic recovery. Monetary policy is not the be-all and end-all of economic policy. It is nothing but an aid, and sometimes an indispensable aid, to sound economic policy. Our economic policy must necessarily be broad-based on the fundamental objective of correcting the distortions in the structure of prices and production created by the Depression. To reach this goal we require a co-ordinated programme in which both monetary and non-monetary measures must be combined and assimilated.

An economic depression which is a process of deflationary contraction always means a tremendous loss of real income. It is possible by monetary measures to keep down the loss of national income

in terms of money to as low a level as possible. But the most pressing economic problem which arises in the course of a depression is that the loss of real income is not *quickly* and *evenly* distributed over all classes of the community. Deflation attacks certain incomes only and thus increases the disparity in real incomes amongst the different economic classes. Thus falling prices in the absence of expansion of total productivity, automatically increase the share of the national income going to that section of the community which has fixed money claims. This rigidity of the debt structure based on contractual money claims is one cause of the unequal distribution of the loss of real income and of the distortion of the structure of production. Another cause is the rigidity of the cost structure. A rigid debt structure helps to create a rigid cost structure. But in the case of the industrial employer there are many other rigid items; at least half of his costs of production is normally represented by such rigid items, including, notably, wages. Wage reductions are not possible because rent and a number of other items comprised in the cost of living do not move in harmony with wholesale prices. As Sir Henry Strakosch has pointed out, in the post-war world a peculiar rigidity has been imported into the cost structure for reasons which he

summarises as follows :—" (a) Increased division of labour, with its corollary of increased overhead and relatively static charges ; (b) increased mechanization coupled with larger individual units of production (again involving a greater ratio of fixed overhead charges); (c) An increased proportion of the world's economic activity devoted to services—i.e., distribution and selling—whose costs do not react rapidly to a fall in wholesale prices ; (d) increased use of credit (whose costs also are sheltered) in the process of production ; (e) increased cartelization of industry, with the inevitable consequence that finished prices tend to move less sensitively than prices of unsheltered primary products."* In a predominantly agricultural country (in which a vast mass of indebtedness hangs like a mill-stone round the neck of the peasantry) the disturbance in the costs-prices equilibrium is likely to be more serious as the prices of "unsheltered" primary products are particularly sensitive. Hence the outstanding evil of the prolonged process of deflation to which India has been subjected has been the unequal and slow distribution of the loss of real income caused by the economic crisis and a corresponding distortion of the structure of production. Any measure by which we can distribute the loss of real income quickly and equitably

* *Lessons of Monetary Experience* p. 175.

amongst all classes other than the agriculturists will be a step towards economic recovery. It will lower the cost of agricultural production, increase the volume of goods that the agriculturists could buy from domestic industry, reduce unemployment, increase the margin between revenue and expenditure in the Central and Provincial budgets, increase the volume of domestic production competing with imports and help to restore our trade balance to a sound and stable basis.

There are several ways of restoring the costs-prices equilibrium and shifting a part of the inequitable burden of loss of real income which rests on the producers of primary products to other sections of the community. There are some who believe that the equilibrium should be restored by an automatic lowering of costs in the *long run,* and when this happens eventually the loss of real income will have been evenly distributed over the community. But they forget that leaving things to nature makes the process of economic adjustment slow and painful to the point of desperation. As Sir Henry Strakosch has explained, a peculiar rigidity has been imported into the cost structure in the post-war world. The costs-prices equilibrium encounters nowadays almost irresistible economic friction, and natural forces are powerless to restore this equilibrium in

a great majority of cases. Moreover, the problem assumes a serious aspect in the case of a country like India, where the disequilibrium is so violent owing to the high sensitiveness of the "unsheltered" prices of primary products, where there is a vast mass of agricultural indebtedness, and where the agriculturists who have borne the brunt of the crisis are least able to bear it. "A primary producing country with a heavy proportion of fixed interest bearing debt cannot enter lightly into a course that will cut in half the prices of its leading products. The debt problem is much too difficult of adjustment on this basis without serious financial disturbance."* It is quite evident that the painful process of deflation has driven the Indian peasantry to a point of desperation. Compulsory scaling down of debts and the abatement and arrears of land revenue demand in all parts of India have been tried as remedies, but they have proved to be desperate palliatives which tend to cure only the symptoms of a deep-rooted economic malady which has reached a critical stage. Compulsory debt settlement of the kind attempted in the various Provinces of India is a method of debt adjustment which has not been free from "serious financial disturbance" in the countryside. It has had a tendency to retard economic recovery, and

*Copland, *Lessons of Monetary Experience*, p 414.

by scaring creditors has very often worked ultimately against the interests of the agricultural debtors, while it has fanned the smouldering fires of class conflict. Abatement and arrears of land revenue demand are also temporary palliatives and cannot really go very far without threatening budgetary equilibrium and accentuating the class conflict. Moreover there is a danger that the Provincial Governments may develop a deflationist mentality. In times of acute economic depression "tendencies to level up incomes which are more often based on vague sentiment than on calm consideration are combined with the puritanical wave. Almost every country, it seems, has at some time during the last depression gone through a period of being plagued by this puritan bad conscience about 'too much spending' and the cry for a 'drastic reduction of expenditure all round'. In Germany the atmosphere was thick with it during the Chancellorship of Brüning, and the British Economy Stunt of 1931-32 seems to have amounted to the same thing."* But the fact is that we are living in poverty in the midst of plenty, and economic recovery being nothing but a process of getting rid of surplus goods and surplus productive capacity, reduction of consumption and ultimately the measures which bring

* Röpke, *Crises and Cycles* p. 182.

about a reduction of consumption can never be a way out of the impassè. One should not deny that a deflationary process has a purging effect, and a certain amount of deflation is perhaps necessary for the restoration of economic balance. Speaking of Japan, Mr. Fukai observes that "the productive capacity of the nation was improved during the period of depression making available a supply of goods at less cost". But Japan, unlike India, did not allow the slow paralysis of economic activity to creep in, and hence, as he says, "when under the stimulus of low exchange and cheap money occasion arose for the advance of our goods to foreign markets, we were fully prepared to make the most of it."*

Another method of redistributing the loss of real income caused by the Depression is to raise the real income of peasants by a compensatory adjustment of the tax structure. This is being attempted by Congress and non-Congress Governments in the Provinces. The section of the community which comprises the fixed interest rentiers, most salary earners, a large proportion of the skilled and upper-grade wage earners and the landlords usually ex-

* Eigo Fukai, *The Recent Monetary Policy of Japan* contributed to *Lessons of Monetary Experience.* p. 393

perience an increase in real income during the period of depression, and hence their taxable capacity rises. Hence a transfer of real income from these classes to the agricultural masses is being brought about by taxing the former more heavily, or by otherwise reducing their real income (through retrenchment, salary cuts and reduced Government expenditure incurred on these classes) and by diverting the resources so obtained to social expenditure benefiting the masses, particularly to providing relief in the shape of reduction of land revenue.* The same object can be still better achieved if the Central Government also introduce salary cuts and economise their expenditure, make the graduation of the income-tax steeper at the higher ranges, introduce Death Duties and re-adjust their tax structure in co-ordination with the Provinces on the basis of a long-run trade cycle policy. Such an economic policy will certainly secure distributive justice and give a much-needed immediate relief to the agricultural masses. But it is at best a palliative and cannot go very far without increasing the burden on economic enterprise, creating class conflict and disorganization, and disturbing social and industrial relations. The repercussions of of these on our economic life may be disastrous,

* The proposed Employment Tax in U.P. is an interesting instance of taxation of this nature.

particularly at a time when we are looking forward to economic recovery. What we should aim at is economic expansion and not mere redistribution of the loss of real income which is being attempted by the Provinces at the present moment. And for this purpose monetary policy is indispensable to a sound economic policy.

Another method which has found favour with some is to correct the costs-prices disequilibrium by restricting the supply of commodities, and particularly that of agricultural commodities of which there is supposed to be a serious glut. As Keynes says, "It may well benefit the producers of a particular article to combine to restrict its output. Equally it may benefit a particular country, though at the expense of the rest of the world, to restrict the supply of a commodity which it is in a position to control. It may even, very occasionally, benefit the world as a whole to organise the restriction of output of a particular commodity, the supply of which is seriously out of balance with the supply of other things."* Schemes of crop restriction have been recently very popular in agricultural countries, and even international organisations have been set up to control and restrict the supply of essential

**Means to Prosperity*, p. 17.

raw materials and primary products on the basis of quotas. In India tea restriction and jute restriction are instances in point. In the cement and sugar industries the control of a sheltered home market behind the tariff wall has also led to the regulation of supply in the face of sagging prices. But obviously in the sphere of agricultural production a restrictionist policy would require an elaborate and expensive machinery of restriction and usually succeeds in the case of crops produced on the basis of a plantation system of proprietary agriculture. But apart from the practicability of restriction schemes, "as an all-round remedy," as Keynes observes, "restriction is worse than useless. For the community as a whole it reduces demand by destroying the income of the retrenched producers, just as much as it reduces supply. So far from being a means to diminish unemployment, it is rather a method of distributing more evenly what unemployment there is, at the cost of somewhat increasing it."* The Columbia University Commission in their Report on Economic Reconstruction indicate the ultimate effect of restriction very incisively when they say that "an all-round application of this policy would make for general impoverishment and would solve the problem of 'poverty

---

* Op. cit. p. 17.

in the midst of plenty' by removing the plenty."* And we are inclined to agree with them when they further say that "deliberate limitation of production and even physical destruction of goods and crops in order to raise the price of the remainder are in effect a confession of failure in respect of our present ability to deal with the major problem."†

It is clear then that the immediate objective of our national economic policy must be economic expansion. But as the first step towards it there must be a frontal attack at the monetary end. The rupee must be immediately devaluated in order to raise the export prices in terms of rupees at least to the level of April 1936, the objective of devaluation being the restoration of the equilibrium between the cost structure and the price structure by quickly raising the export prices in terms of rupees. The Reserve Bank should at once give up the attempt of maintaining the present ratio and cease to make inroads upon the sterling assets of the Issue Department. On the other hand, if necessary it should start purchasing gold and sterling in sufficient quantities so as to reach and maintain the depreciated level of exchange decided upon as a measure of devaluation

---

* Report of the Columbia University Commission, Columbia University Press, 1934, p. 38.

† Op. cit. p. 12.

and to minimize the effects of foreign exchange fluctuations. For some time in order to check speculation it must retain its deflationary grip upon the money market and desist from active expansion of of currency and credit. That such a course of action is necessary is borne out by the monetary experience of Sweden, Great Britain and Australia. The immediate impact of exchange devaluation will be upon the international price level expressed in terms of rupees which will rise at once and almost in proportion to the extent of depreciation. Gradually the domestic price level will rise somewhat to the extent that the impetus of devaluation and the consequent expansion of purchasing power diffuse themselves through the economic system and affect that price level by an indirect process. But after a stage there must come stimulation of loan expenditure which Keynes regards as the means to prosperity. The first necessity, according to him, is "that bank-credit should be cheap and abundant. This is only possible if each Central Bank is freed from anxiety by feeling itself to possess adequate reserves of international money."* The Reserve Bank has no doubt lost a considerable amount of its sterling assets in the Issue Department, but still the ratio of A to Liabilities of the Issue Department is about 10 p.c.

---

* *Means to Prosperity* p. 20.

above the legal minimum, so that there is still considerable scope for expansion of note-issue. As Keynes suggests, even "the abatement of the legal proportion of international money" (gold and sterling securities in the case of India) which the Reserve Bank must hold against its note-issue "might also help on a minor scale." * Moreover since devaluation will mean an immediate appreciation of the value of gold and sterling securities in terms of rupees the scope for expansion of note-issue will to that extent be widened. Thus, on the whole, it will be necessary and possible for the Reserve Bank to bring about an increase in the amount of notes in circulation and in the amount held in the Banking Department to facilitate loan expenditure. Purchase of securities and a lowering of the Bank Rate to 2 p.c. (as was done in England in June, 1932) will also perhaps be necessary as supplementary measures. All these and other allied measures of real credit expansion are absolutely necessary if devaluation is to succeed, otherwise a dangerous reaction is bound to occur sooner or later in the same way as it occurred in the United States during the first year of the New Deal until a real expansion of credit was started.†

---

* Op. cit p. 20.

† Röpke, *Crises and Cycles*, p. 190.

As Keynes says, provision of ample short-term bank credit is just the first stage in the programme of recovery. We explained above that when there is still disequilibrium between the cost structure and the price structure an easy money policy fails to have an expansionary effect. Liquidity preference being high in the case of long-term loans necessary for expansion, a large differential appears between the long-term rate of interest and the short-term money-rate. Hence the low short-term money-rates serve an expansionary purpose only when long-term capital can be obtained on easy terms and there is increased demand for short-term credit to replace the working capital. As Keynes suggests, "a combination of manoeuvres by the Government and the Central Bank in the shape of open-market operations by the Bank" is expected to lower the long-term rate of interest for reasonably sound borrowers.* Something of this kind will be necessary in India if economic expansion is to gather momentum.

Keynes is of the opinion that economic expansion can not be financed out of current income which has fallen too low. The increased spending power which is to initiate and speed up the process of expansion must come out of loan expenditure on a large scale.

* *Means to Prosperity*, p. 21.

Compensatory credit expansion which draws upon unused productive reserves corresponding to the deficit of purchasing power created by deflation, is certainly a source of loan expenditure. But Keynes thinks that the first step in initiating loan expenditure "has to be taken on the initiative of public authority; and it probably has to be on a large scale and organised with determination if it is to be sufficient to break the vicious circle."* This brings us to the public works policy as a means of fighting depression. The general principle involved in this policy is that the process of credit expansion should start with the state as the pioneer in starting new borrowing instead of the nervous and hesistant entrepreneurs. Once the principle is accepted the rest is a question of technical detail. Already the Provinces have been evolving their reconstruction programmes requiring public works and projects of a productive character. There is thus a vast amount of productive expenditure that is waiting to be incurred on a nation-wide scale. Let this expenditure be loan expenditure on a large scale and, in the words of Keynes, "organized with determination." For this purpose we must have an All-India Loans Council like the Australian Loans Council, which will co-ordinate the loan issues and determine their order and timing in

* Op. cit p. 22.

such a way as to prevent too many competitive loan issues at a time and avoid a rise in the terms on which credit can be obtained. The best policy is to tap the short-term capital market by selling Treasury Bills, because the short-term money rates at the moment are lower than the long-term rates and are likely to be so at the initial stage. This may be financial unorthodoxy but is certainly the most rational way of financing loan expenditure for fighting a depression. But the Reserve Bank will have to thoroughly revise its policy regarding the sale of Treasury Bills on behalf of the Provincial Governments. It must itself purchase these Bills as part of its policy of credit expansion and thus enable the Provincial Governments to borrow money for economic expansion on reasonably low terms and must determine the order and timing of the Treasury Bill tenders on a rational and co-ordinated plan in consultation with the proposed All-India Loans Council.

INDEX

D.

L

M

N

O